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ECONOMIC OUTLOOK

Chamber of Commerce of the United States

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REASSESSMENT OF THE NEAR TERM OUTLOOK

by

Richard W. Rahn and Ronald D. Utt

As the economy progresses through the third quarter, it is becoming increasingly unlikely that the Chamber's earlier projection of 4 percent to 5 percent growth for the second half of the year will occur. Instead, economic growth on the order of 3 percent for the next few quarters seems likely to be the best we can expect. This downgrading stems largely from the economy's performance during July and August and suggests that the slowdown that began in mid-1984 is still very much in evidence. An overview of several key sectors of the economy, discussed in detail below, illustrates this point, as well as some of the frustrations that forecasters confront in their efforts to make some sense out of the current economic situation. Nonetheless, there are a growing number of positive signals which suggest that the economy will end the year on a significantly stronger note.

The Housing Sector

The housing sector, a major component of the gross national product and an important bellwether of economic trends, has yet to emerge from its doldrums despite the substantial improvements in those factors that influence the course of the housing market. As was noted in last month's issue of the *Outlook*, housing starts had been drifting down from the near-term peak of 1.9 million units (seasonally adjusted annual rate), reached in April to nearly 1.7 million units in July. So far this year, housing starts are running 6 percent below the comparable period in 1984. What is ironic about this performance is that it has occurred in the face of a substantially improved housing finance market.

Fixed-rate, thirty-year conventional mortgages are now available at 12.2 percent compared to 14.5 percent a year ago. Moreover, adjustable rate mortgages, which account for as much as 60 percent of new mortgage originations, now carry rates as low as 8.5 percent, offering affordability opportunities not seen since brief periods in the mid-1970s. Coincident with the decline in mortgage interest rates has been an ample flow of mortgage credit from a variety of financial institutions and markets. This has permitted continued availability of low-downpayment mortgages. Finally, the excessive home price inflation of the past, which propelled prices up at rates exceeding growth in incomes, has ended. Offsetting these favorable finance trends is a burgeoning inventory of unsold homes and vacant apartments. Since the last quarter of 1984, the rental vacancy rate has remained above 6 percent, the first time it has pierced this level since the late 1970s. At the same time, the homeowner vacancy rate during the second quarter, at 1.9 percent, was the highest rate in any second quarter since 1956.

Although the housing production sector struggles to maintain last year's production rate, sales of new and existing homes, an important indicator of future production, have held up reasonably well. Since the beginning of this year, sales of newly built homes have drifted between the 630,000 to 690,000 annual unit sales range, but jumped to 704,000 units in July, the highest level since late 1983. On a year-over-year basis, sales are 15 percent ahead of last year's level. Sales of existing homes are doing even better. In July, sales of existing homes reached their highest level since October, 1980. If these trends continue, and the recent declines in mortgage interest rates suggest they should, the production rates should soon turn up from their current levels once the excess inventory is worked off.

Other Sales, Personal Income

Trends in the domestic automobile market show some-

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what more weakness than the housing market, although recently introduced sales incentives may soon change this. Domestic auto sales averaged 8.4 million units (seasonally adjusted annual rate) in the first half of the year but dropped to 7.4 million units in July and 6.8 million in early August. To some extent, the just settled auto haulers strike contributed to the decline. Sales did bounce back to an annual rate of 7.6 million units for the mid-August period, but this was below the level of performance for the first half of the year and almost 5 percent below the same period a year ago. The modest increase that did occur in mid-August may reflect the end of the strike and the concessionary finance terms and/or price discounts that have just been implemented by auto manufacturers.

Unlike the housing market, which is free from any international competition, the domestic auto industry is becoming increasingly hard pressed by foreign suppliers, particularly by the Japanese whose production efficiencies and favorable exchange rate make them formidable competitors. Following the dismantling of the auto import quotas in March, Japanese cars have made substantial inroads into the domestic market. In 1984, when the quotas were in effect, Japanese cars held 18.3 percent of the market. In July, 1985, the share reached 23 percent and is expected to rise even further now that the strike is over and inventories are in the process of being replenished.

Total retail sales have followed essentially the same trend as the auto and housing markets since the first half of this year. After reaching a peak in April, monthly retail sales have drifted down in each of the succeeding months. Revised June sales were below those of May, and July was little changed from June. Although July sales, before adjustment for inflation, were up more than 5 percent from last year's level, the year-over-year gains have been narrowing since early spring.

If personal income is any guide to future sales trends, the near-term performance of the U.S. economy may see more of the same. Inflation-adjusted personal disposable income fell by 2.5 percent in June and, based on preliminary estimates of nominal income growth, is likely to have fallen again in July. What strength there was in June was due largely to retroactive Social Security payments that offset the stagnation in wages and salaries. Personal consumption expenditures did not do as poorly as this because consumers were able to maintain spending by decreasing savings. The personal savings rate has been below 5 percent for most of this year and is now the lowest it has been in two years. Preliminary estimates for June and July place it at 3.4 percent of disposable income. Although the monthly personal income statistics are subject to numerous estimation errors, including the complete neglect of the increasingly popular 401(k) plans, recent increases in consumer installment debt confirm this trend. Obviously, if personal income continues its recent pattern of slow growth, consumer spending, which has been one of the stronger components of the GNP so far this year, may soon experience some slippage.

Reflecting the slow growth in the economy, corporate profits of nonfinancial businesses, adjusted for changes in inventory valuation and capital consumption allowances, have been largely unchanged since the peak reached in the first quarter of 1984. However, profits reported for tax purposes have declined somewhat over the same period. The same is true for after-tax corporate profits which have now fallen for five consecutive quarters.

Despite weakening profits, business fixed investment continues to be one of the strongest sources of growth in the economy. After declining by nearly 2 percent in the first quarter, the first decline since mid-1982, investment resumed growing at double-digit rates during the second quarter. The 11.8 percent increase, made this sector the outstanding performer in an otherwise lackluster quarter. With interest rates down, corporate cash flow up and American businesses still facing competitive pressures that necessitate high levels of efficiency, investment should continue at these rates for at least the next four quarters, provided that the economy continues to advance at or above its present growth trends.

Nonetheless, manufacturers' attitudes about the current state of the economy remain depressed. In August, the Purchasing Managers' Composite Index stood at 46.7 percent, the seventh consecutive month that the index has been under 50 percent. Reflecting their gloomy assessment of the situation, purchasing managers polled by the National Association of Purchasing Management in July reported that production in that month had fallen to the lowest level since December, 1982. This assessment is at sharp variance with the government's index of industrial production.

Foreign Trade: A Source of Concern

Beginning in 1983, the U.S. balance of trade turned negative and has worsened substantially with each successive quarter. As the rapid growth in imports overtook exports and the difference continued to widen, the unfavorable trade balance began to exert a significant negative impact on the GNP accounts. From a current dollar deficit of $8.3 billion in 1983, our net export position in goods and services, as measured in the national income accounts (NIA), widened to $93.4 billion during

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the second quarter of 1985. Had our balance of trade not deteriorated further during the second quarter, growth in GNP would have been more than 50 percent higher (3.1 percent versus 2.0 percent) than the rate of growth actually recorded.

The deterioration that has occurred in our trade account since 1983 can be divided into two distinct periods according to the trends in exports and imports that have contributed to the widening deficit. From 1983 to mid-1984, both exports and imports increased, but imports increased at a faster rate, causing the trade balance to deteriorate. From 1983 to 1984, U.S. merchandise exports grew by 8.7 percent while imports grew by 26.2 percent. Since late 1984, however, U.S. exports have shown little or no growth. During the first half of 1985, exports, on a current dollar basis, increased by only 1.9 percent from the same period a year ago. After adjustment for inflation, they have actually fallen. Imports, on the other hand, increased by 7.6 percent over the same period. Although overall growth trends have recently moderated, the disparities remain.

Conflicting forces on the trade sector make it difficult to discern the direction of U.S. trade patterns for the next twelve months. On the positive side, the trade-weighted value of the dollar has fallen by 11 percent from its February peak. However, the effect of this change will not be reflected in the trade data for some time. Moreover, the dollar still remains well above its 1980 level. Also on the positive side is the slower growth in the U.S. economy which will lead to slower growth in purchases from abroad. This has already been reflected in the second quarter. On an NIA basis, there was no change in the real value of imports between the first and second quarter. What deterioration in our trade account did occur was largely due to a fall in exports over the first half of the year. On the negative side, the decline in exports may continue, despite the more favorable dollar, because the economies of our major trading partners are slowing down as well, in some cases at a rate of decline exceeding our own. In the most recently reported three month period, when U.S. growth was only 2 percent, economic growth in Germany, France, Sweden and Switzerland was negative while Japan posted a negligible gain of 0.4 percent. The developing countries, which represent a major market for U.S. goods and services, are still struggling with their debt and are unlikely to reduce import restrictions any time soon.

Emerging Signs of Renewed Strength

Although there is much to be concerned about, some sources of strength are still apparent. Despite the conventional wisdom that we are in the process of *de-industrializing* and that imports are shrinking our manufacturing sector, the index of industrial production continues to advance each month, albeit at slower rates that those experienced during the past two years. In July, it rose two-tenths of a percent for the seventh consecutive monthly increase. Each of these increases have been modest, however, leading to a year-over-year gain of only 1.4 percent. Nevertheless, virtually all major components of the index have participated in this increase, but defense and space equipment have clearly performed far better than any other industry this year. Production of both consumer goods and business equipment have advanced, while parts and materials have fallen somewhat.

So far, most of this article has focused on present trends and their implications for the current state of the economy. Although the sluggish performance in major business segments has spilled over into some measures of consumer and business sentiment, the picture remains basically one of optimism. Last month's *Outlook* noted that the May index of consumer sentiment had fallen to its lowest level since 1983. But in the months since, it regained some of the lost ground. The June index jumped to 96.5 from 91.8 in May and then fell somewhat to 94.0 in July. Similarly, the Department of Commerce's index of leading indicators continues to rise, presaging future strength. After showing steady declines in the last half of 1984, the index has since returned to the levels that prevailed in early 1984 when the economy was booming. The July increase marked the sixth rise in the last seven months.

Supporting a more optimistic assessment of the near-term outlook is the Chamber's own Early Outlook Sales Survey for August which indicates that more and more retail establishments believe that sales are in the process of turning up. Following three consecutive monthly declines in the percentage of respondents who believe that their sales are much higher or somewhat higher than the previous month, the August response rate jumped to 62 percent, the highest since December, 1984 and substantially above the 45.6 percent recorded in July.

Although our expectations of future growth have been lowered, we continue to maintain the view that the economy will soon break out of its year long period of drift and move up to a higher rate of growth. As has been the case in our previous reviews of the outlook, our optimism for the future stems from the rapid and sustained growth in the money supply, as measured by M1, over the past ten months. Sooner or later, this has to lead to a strong advance in the economy. Since last November, the money supply has risen at an annual rate of almost 12 percent, an exceptionally high rate of increase for such a lengthy period of time.

Historically, there is a close relationship between growth in the money supply and growth in the economy. Although the relationship is by no means exact, generally, an acceleration (deceleration) in the growth of the money supply leads to increased (decreased) growth in

TABLE I
UNITED STATES ECONOMIC OUTLOOK 1984-1987
Prepared by the U.S. Chamber of Commerce

Percent change from previous period at a seasonally adjusted annual rate

	QUARTERS									YEARS			
	Actual		Forecast							Actual	Forecast		
	85:1	85:2	85:3	85:4	86:1	86:2	86:3	86:4	87:1	1984	1985	1986	1987
GROSS NATIONAL PRODUCT													
Real GNP	0.3	2.0	3.2	4.0	4.2	3.7	3.1	3.2	2.5	6.8	2.5	3.6	2.5
Consumption	5.2	5.4	2.3	3.1	2.2	1.9	1.3	1.6	1.9	5.3	4.0	2.4	1.4
Residential Investment	5.5	5.4	4.4	6.4	0.1	5.1	-2.8	5.4	-5.8	12.2	1.7	3.0	-2.4
Business Fixed Investment	-1.5	11.8	7.1	7.3	8.7	7.5	8.2	7.0	2.4	19.8	7.6	8.0	3.7
Equipment	-5.6	13.2	8.3	8.0	9.6	7.9	9.1	7.1	1.1	21.5	6.9	8.8	2.9
Structures	9.8	8.1	4.1	5.7	6.7	6.5	5.9	6.8	5.7	15.6	9.5	6.1	5.7
Exports	-8.9	-13.0	4.1	5.2	11.8	14.4	13.9	14.9	11.6	4.7	-3.3	8.8	12.9
Real Net Exports (72$B)	-28.4	-33.3	-33.9	-33.7	-31.4	-29.0	-26.7	-23.9	-21.8	-15.0	-32.8	-28.8	-17.4
Imports	32.2	0.0	6.5	4.6	4.1	5.9	5.9	5.9	5.0	27.0	8.0	4.9	4.6
Government Purchases	0.9	0.0	5.3	6.5	6.2	4.9	4.6	2.9	2.4	3.5	7.1	5.1	2.6
Real Final Sales	-0.3	4.7	2.8	3.8	3.8	3.6	3.0	3.2	2.2	5.0	3.3	3.5	2.4
Industrial Production	0.7	2.7	2.7	5.5	6.4	5.8	4.6	5.2	3.3	10.6	2.9	5.1	3.4
Change in Business Inventories (72$B)	19.1	8.3	10.1	10.5	12.4	13.2	13.7	13.9	15.6	24.8	12.0	13.3	16.8
New Car Sales (total, mill.)	10.9	10.9	10.9	10.9	10.6	10.7	10.9	10.8	10.9	10.4	10.9	10.7	10.5
New Domestic Car Sales (mill.)	8.5	8.2	7.8	7.8	7.7	7.7	7.5	7.2	7.3	8.0	8.1	7.5	6.8
New Housing Starts (total, mill.)	1.8	1.8	1.7	1.7	1.7	1.7	1.7	1.7	1.6	1.8	1.7	1.7	1.6
EMPLOYMENT, WAGES AND PRICES													
Civilian Unemployment Rate (%)	7.3	7.3	7.3	7.1	7.0	6.8	6.8	6.7	6.6	7.5	7.3	6.8	6.7
Compensation	5.4	4.1	4.2	4.2	4.8	4.3	4.3	4.4	4.7	4.2	4.3	4.4	4.5
Productivity	-3.0	1.0	0.3	1.1	1.6	1.4	1.0	1.2	0.8	2.7	0.1	1.2	0.9
Unit Labor Costs	8.4	3.1	3.8	3.1	3.2	2.9	3.3	3.1	3.9	1.4	4.1	3.2	3.6
Consumer Price Index	3.3	4.2	2.8	3.0	3.6	3.9	4.3	4.2	4.6	4.3	3.5	3.7	4.5
Implicit GNP Deflator	5.4	2.7	3.2	3.0	3.3	3.6	3.6	3.6	4.3	3.8	2.7	3.3	3.9
Prime Interest Rate (%)	10.5	10.2	9.5	9.4	9.3	9.4	9.5	9.6	9.8	12.0	9.9	9.5	9.9
3-mos. Treasury Bill Rate (%)	8.2	7.5	7.2	7.1	7.1	7.1	7.2	7.4	7.5	9.5	7.5	7.2	7.5
Corporate Bond Rate (%)	12.3	11.6	11.1	10.7	10.4	10.2	10.0	9.8	9.8	12.7	11.4	10.1	9.7
Profits from Current Production ($B)*	207.0	212.7	205.3	219.7	227.4	234.4	235.5	239.6	241.9	195.9	211.2	234.2	311.9
GOVERNMENT FISCAL POLICY ($B)**													
Unified Receipts										666	750	787	844
Unified Outlays										842	954	989	1035
Unified Deficit										-176	-204	-203	-191

*After-tax corporate profits with inventory valuation and capital consumption adjustments.

**Unified Budget figures on a fiscal year basis.

SOURCE: U.S. Chamber of Commerce, Forecasting Section, using the Washington University Macroeconometric model of the U.S. economy.

FORECAST ASSUMPTIONS

This month's forecast contains the Commerce Department's revision to the National Income and Product Accounts for the second quarter of 1985. It continues to take into account all the provisions of previously enacted legislation, including indexation of personal income tax rates. Congress is assumed to pass a deficit reduction package which results in a static reduction in federal government outlays of $44 billion in 1986 and $68 billion in 1987. The nation's money supply, as measured by M(1), rises by 8.4 percent in 1985, 7.4 percent in 1986 and 6.1 percent in 1987. The federal minimum wage remains at $3.35 per hour throughout the forecast interval. The price of a barrel of imported crude oil averages $25 and $23 in 1986 compared to $28.9 in 1984. The trade-weighted exchange value of the dollar rises 4.2 percent this year on a year-over-year basis. During 1986, it falls by 10.5 percent, and an additional 6.2 percent in 1987.

real GNP within six to nine months. Beyond this, however, the monetary stimulus usually leads to accelerating inflation and an economic reversal. To some extent, the experience in late 1984 and early 1985 conformed to these trends. From May to November of 1984, the money supply grew hardly at all and this could have contributed to the stagnation experienced in the months that followed. However, with the reversal in policy that began last November, it would be expected that the economy would have reversed course as well. That it did not remains one of the mysteries of this business cycle and one of the chief reasons why our forecast for 1985 went awry.

Conclusion

We do not anticipate that this mystery will remain for much longer, and fully expect the business expansion to move forward at a more rapid pace toward the end of this year and continue through 1986. However, because of the many prevailing weaknesses documented in this article, we expect the recovery to advance at rates somewhat less than we anticipated earlier.

On a final note, we want to reiterate our concern, first expressed in the June, 1985, issue of the *Outlook*, about the quality of the government's economic statistics and the extent to which the reported numbers underestimate or improperly account for numerous measures of economic performance. Earlier this year, a report by the Council of Economic Advisors noted that the Department of Commerce's failure to account for declining computer prices led to a 1.2 percentage point understatement of the rate of growth in real GNP in 1984. More recently, the divergence between employment trends and reported GNP growth in 1985 suggests that this and similar problems may persist. In the first quarter of this year, employment data indicated that aggregate hours worked increased 17 times faster than the increase in the volume of goods and services produced, as reported in the GNP accounts. These and other factors, including the absence of good, detailed data on the rapidly growing service sector, suggest that the economy might be doing better than what the official statistics reveal.

REGIONAL SURVEY

by
Rajni Bonnie Ohri

During the past year, measured gross national product has posted very weak rates of growth relative to the experience of the first year and a half of recovery. Although domestic demand has remained strong, marked increases in imports have offset the strength evident in other sectors of the economy. U.S. demand for foreign goods and services has provided virtually the only engine for growth in the global economy, without which worldwide economic activity would have remained in the doldrums. The outlook for the next two years, as the previous article explained, is for continued, albeit, slower growth in the United States. Just as measured GNP masks the strength in domestic demand, measures of overall economic performance tend to obscure differences in economic activity among the nation's industries and regions.

This article examines regional economic performance during the past year, focusing on factors which account for the disparity in economic conditions encountered around the nation. The analysis shows that those areas that have benefited the most from the strength of the expansion share similar industrial characteristics, such as a diversified industrial base and a favorable business climate. Areas which have a tendency to lag behind are relatively more dependent on industries and sectors which have not performed as well as the economy as a whole, including heavy manufacturing and farming. Industrial concentration, as in the case of the East North Central region, may contribute to powerful, even spectacular, growth for years. But, as the experience of Texas, Louisiana, and Alaska shows in the case of energy, this concentration renders the regions extremely vulnerable to changes in economic conditions. On the other hand, regions such as the Pacific and New England, which enjoy a greater industrial diversity within their borders, are more likely to be able to adapt to changing economic conditions.

Most states now realize that they can no longer rely solely on their tradition of industrial prowess or their existing manufacturing base, and are developing new information-age strategies to remain competitive in a vastly different economic environment. Around the country, high technology firms are sprouting up beside farms, factories, and tourist centers. California's Silicon Valley still leads in high-tech activity, but Florida, Massachusetts, Texas, New Hampshire, and North Carolina are close on its heels.

Recognizing that the U.S. economy is now intimately integrated with the world economy, and that fundamental changes are taking place there as well, a number of states have sent trade missions overseas in an effort to lure foreign businesses to their borders. Many states—Georgia, Florida, Oregon, Tennessee and New Mexico, among them—have experienced phenomenal success by systematically removing barriers to foreign relocation. In addition, more states are becoming aware that exporting is an integral part of their economic development. Oklahoma has led the way in integrating its export programs, and Texas and Nevada have also created new export finance facilities. Thirty states now have offices in 11 different countries.

OVERVIEW

America's demographic profile reflects a continuing

urge to follow the sun. Between 1980 and 1983, the fastest growing regions were still the South and West. By the year 2000, California will still be the most populous state, but Texas and Florida will likely nudge New York out of its second place ranking and push it to fourth, as population growth in those states places them in second and third place, respectively. Although migration accounts for some of the growth in the South and West, states in the Northeast and Midwest will not be turning out the lights. The latest census data show Ohio, Indiana, Michigan, and Iowa growing again after losing population in 1981-82. All New England states recorded a gain in 1984, with Massachusetts showing the fastest growth rate. In fact, only three states—West Virginia, Oklahoma and Wyoming—lost population in 1984, but none dramatically.

TABLE 1
PER CAPITA INCOME BY REGION
($ Thousands)

	1984	1983	Percent Change
U.S. Total	12.7	11.8	9.7%
New England	14.2	13.0	10.2
Middle Atlantic	13.8	12.7	8.8
South Atlantic	12.0	11.1	10.5
East North Central	12.6	11.5	10.2
West North Central	12.5	11.3	11.3
East South Central	10.0	9.1	9.8
West South Central	11.9	11.1	9.0
Mountain	11.7	10.9	9.3
Pacific	13.9	12.9	9.3

Source: Survey of Current Business, April 1985

Per capita personal income for the nation as a whole posted a healthy 9.7 percent increase in 1984 compared to 1983 (see Table 1). The South Atlantic, New England, and North Central states enjoyed above average income growth, while the slowest growing regions were the Middle Atlantic and West South Central. State per capita income in 1984 ranged from $17,155 in Alaska to $8,857 in Mississippi, compared to a national average of $12,707.

TABLE 2
RETAIL SALES BY GEOGRAPHIC AREA
(Percent Change, April '84–April '85)

U.S. Total	7.4%
New England	4.0
Middle Atlantic	5.3
South Atlantic	8.5
East North Central	10.4
West North Central	7.6
East South Central	3.9
West South Central	4.0
Mountain	8.1
Pacific	9.6

Source: U.S. Department of Commerce

In the year to April 1985, national retail sales increased 7.4 percent. Regional performance ranged from a 10.4 percent increase in the East North Central region to only 3.9 percent in the East South Central (see Table 2). The data agrees with results from the latest Chamber retail sales survey, a nationwide compilation of retailers' attitudes, which shows a similar regional breakdown of total retail sales.

TABLE 3
UNEMPLOYMENT RATE
(Percent of Labor Force)

	May 1985	May 1984
U.S. Average	7.3%	7.8%
New England	4.6	5.0
Middle Atlantic	6.2	6.7
South Atlantic	6.4	7.3
East North Central	8.1	9.0
West North Central	5.4	5.5
East South Central	8.3	9.6
West South Central	7.9	7.8
Mountain	6.8	6.5
Pacific	7.7	8.3

Source: Bureau of Labor Statistics

In May of this year, the nation's civilian unemployment rate stood at 7.3 percent, down from 7.8 percent in May 1984. As Table 3 shows, most of the regions shared in this improved employment situation. New England's jobless rate is 4.6 percent and falling fast. However, in the East South Central states, the unemployment rate is still over eight percent, and in the West South Central and Mountain regions, more people were out of work this year than last. The states with the highest unemployment rates are West Virginia, Illinois, Pennsylvania, Michigan, Iowa, and Ohio. Arizona, Georgia, and New Hampshire, on the other hand, have enjoyed the most rapid growth in jobs this year. By industry, nearly every state reported job gains in trade, services, finance, insurance and real estate, and over one-third had increases in manufacturing employment.

New England

Connecticut, Maine, Massachusetts, New Hampshire, Rhode Island, Vermont

Once dominated by textile mills and shoe factories, New England is now dotted with high-tech firms, service industries and some of the nation's finest recreational facilities. A recent study by the Naisbitt Group cited Connecticut, Massachusetts, and New Hampshire among the top ten states with the best business environment, particularly for small business.

At 4.6 percent, New England's unemployment rate is the lowest in the nation. Reflecting the strength in regional employment, 1984 per capita personal income

was 0.5 percentage points above the national average. Correspondingly, manufacturing wage levels have increased over 5 percent in most of the states in the region. Indeed, regional economic growth appears to be outpacing rapid labor force expansion. Industry analysts estimate that 180,000 new jobs will be created in New England this year, up from 156,000 in 1984. The rise in total employment has improved consumers' real disposable income, creating greater demand for services, durable goods and houses.

At the heart of New England's growth is its strong high-technology manufacturing sector. In 1984, private companies invested nearly $200 million and the government spent an additional $61 million creating new opportunities in high-tech industries in Lowell, Massachusetts. The city now boasts the lowest unemployment rate in the state and the fifth lowest in the country. Massachusetts' Route 128 area, the East Coast version of California's Silicon Valley, is booming with electronics firms and will see continued growth this year. Connecticut's economy also continues to charge ahead, principally on the strength of increased defense contracts and strong orders for transportation equipment. Maine's service-oriented economy is solid and growing. Moreover, the Navy's recent decision to award a $321 million contract to build a new class of destroyers at the Bath Iron Works should boost manufacturing employment. New Hampshire's unemployment rate is 4.5 percent, and may drop even further when Data General opens its Durham plant and Apollo Computers hires new workers for its Hampton plant. Together, these two firms should create 2,200 new jobs in the state. In an effort to stimulate farming, Vermont state officials will help farmers to develop new markets for their products. The state is also creating a private, profit-making venture capital corporation to give small businesses a leg up. Rhode Island, which has not yet been swept up in the high-tech tide, continues to lag the regional upturn. However, the state is currently undergoing a revitalization of its business climate and should see rapid job growth this year.

The construction boom and the mix of industry within the states helps to explain the robust economic growth of New England. Construction of new homes turned in a tremendous increase this year compared to last year's performance and the construction industry expects another profitable year. With over a quarter of its manufacturing output in electronics, computers, instruments, nonelectrical machinery and machine tools, the region has an impressive base of products. Most of these industries are expected to grow by over five percent this year as compared to 1984. Business services are also growing rapidly, reflecting the strength in manufacturers' demand for research and development and data processing services. The sore spots on the economy are the fabricated metals industry, which will see growth of only 1.5 percent, and the leather products industry which is projected to lose a substantial portion of its market share. The jewelry industry, which accounts for over six percent of all jobs, is also expected to decline as foreign competition continues to take a larger share of the U.S. market.

Middle Atlantic

Delaware, New Jersey, New York, Pennsylvania

The Middle Atlantic region should fare well this year. Manufacturing output for its basic industries is up, personal income is rising, and retail sales are strong. However, population in the region is growing at the slowest rate in the nation. The average unemployment rate was 6.2 percent, with Pennsylvania showing the highest jobless rate at 8.4 percent. Most of the region's lackluster employment performance can be attributed to its dependence on heavy industry. Nevertheless, industry analysts expect that 100,000 new jobs will be created this year in high-tech and service industries of the New York/New Jersey area.

Last year's increase in regional housing construction was the highest in the nation. Housing demand continues to encourage significant increases in construction employment and the construction-related industries such as stone, clay, brick and glass. The electrical equipment and nonelectrical machinery sectors, which make up one-sixth of the manufacturing output in the region, should continue to exhibit strong growth. The instruments industry has made an impressive recovery, with Eastman Kodak responding to foreign competition by streamlining operations and boosting employment in the Rochester, New York area. The decline of the region's apparel and primary metals industries reflects manufacturers' inability to compete with foreign products. However, the strength and the stability of the region's nonmanufacturing sector, in particular finance, insurance and real estate, will continue to invigorate the regional economy.

Diversification of their existing industrial base with an emphasis towards promoting high growth sectors promises to substantially improve the economic performance of the Middle Atlantic states. Pennsylvania has focused on the computer and robotics industries. The state ranks sixth in the country in university-based research which now stands at more than $280 million a year. Internationally renowned Carnegie-Mellon University is pioneering research in robotics, computer sciences, and artificial intelligence within the state. Recently, Rand McNally, to the nation's surprise, named Pittsburgh the best American city in which to live. In the past decade, Pittsburgh has quietly replaced its declining steel industry with high technology and service-related industries. Many of the remaining steel mills have been scaled down and are in the process of becoming automated. Financial services, high-tech manufacturing, and a strong tourist industry are turning New York's economy around. Further, the vast printing and publishing industry in the state is expected to grow by four percent this year.

The spread of high-tech industries in eastern Pennsylvania and southern New York should help offset the weakness of the traditional smokestack industries. Both Delaware and New Jersey's service and tourist industries are thriving. New Jersey is also home to a number of electronics firms, which expect average earnings to increase this year between 15 to 20 percent.

South Atlantic

District of Columbia, Florida, Georgia, Maryland, North Carolina, South Carolina, Virginia, West Virginia

A good climate, low unionization, and access to major markets makes the South Atlantic region particularly attractive to manufacturers. Although once a mecca for manufacturers looking to escape high labor costs in the Northeast, low wages may not be what attracts manufacturers to the South Atlantic in the future. Wages are being driven higher by the influx of high paying, high technology jobs and labor shortages. Florida, Georgia, and North and South Carolina have all experienced increases in average hourly wages. Unemployment in the region stands at 6.4 percent, the third lowest in the nation, after New England and the Middle Atlantic. Per capita personal income has increased by 10.5 percent in 1984 compared to a national average increase of 9.7 percent.

Of all the states in the region, Florida and Georgia show the strongest economic growth. In Florida, in-migration is expected to boost the state's population, further strengthening housing and retail sales as personal income growth outpaces that of the nation. Defense spending will exert a powerful influence on the economy and should engender further growth in defense-related manufacturing. The agricultural sector in Florida, however, is suffering from an outbreak of citrus canker following two years of damaging freezes. As a result, imports from Brazil are taking a greater share of the state's $1 billion citrus industry.

Continued strength in transportation and wholesale trade will help Georgia's economy, increasing job creation by 5.2 percent this year. The restructuring of Georgia's textile industry will continue to burden the manufacturing sector. However, this may be offset by an extensive defense-related manufacturing industry whose growth prospects are good. Construction of the $1.4 billion Kings Bay Trident submarine base will continue to create new jobs. Similarly, the production of military airlift jets by Lockheed-Georgia in Marietta will boost employment in the state.

At present the South Atlantic region is laboring under the strain of its declining textile industry which has been devastated by stiff foreign competition. In the Carolinas, which account for 60 percent of the nation's textile employment, unemployment is expected to climb as 6,000 textile jobs are lost this year. However, the disappearance of several textile mills may, in part, be offset by the emergence of high-tech businesses in the area. Aided by higher cigarette prices and lower unit costs, the region's tobacco industry earnings are beginning to show a slight increase this year.

The mix of service-related industries in the region have provided some insulation from the employment declines that plagued its manufacturing-dominated economy. Florida has become a center for international banking, focusing on financial relations with Latin America. Companies in northern Virginia are snaring huge defense contracts, which along with tourism and services, are keeping Virginia's economy strong. Biotechnology, computer technology and service industries will contribute most of the 360,000 new jobs projected by 1990 in Maryland alone. In Maryland and North Carolina, the electronics equipment sector, primarily in communication gear, is estimated to grow by nine percent this year. The industrial chemicals and plastics industry has also grown considerably in West Virginia, South Carolina, and Florida.

Although West Virginia's steel industry may never reach previous levels of output, Weirton Works, now employee-owned, is once again in the black and has come to symbolize the industry's rejuvenation. However, coal mining has been stagnant for three years and no upturn seems to be in sight. Unemployment in the state is still the highest in the nation, standing at 11.6 percent as of May 1985.

East North Central

Illinois, Indiana, Michigan, Ohio, Wisconsin

The region's unemployment rate stands at 8.1 percent, the second highest in the nation. Combined with low growth in total employment and the nation's highest wage levels, the region's manufacturing labor costs are pricing industries out of their markets. Michigan's average manufacturing wage rate, at $12.68 per hour, is still a third higher than the national average. The state's unemployment rate stands at 9.8 percent.

Although the region is still tied to agriculture and smokestack industries, government officials and private industry leaders in the East North Central area are attempting to create an environment conducive to new business growth. A substantial recovery is clearly underway in the region's basic industries. Transportation and other machinery account for over a third of the manufacturing strength of the area and industry output is expected to increase by over four percent this year. Automakers are planning to maintain their ambitious third quarter production plans despite some weakness in sales and the recent Teamsters strike against car haulers. Moreover, several states are wooing foreign automakers

to set up production facilities in their area. Honda Motor Company Ltd., Japan's third largest car company, has created hundreds of new jobs in its Marysville, Ohio plant. And Mazda Motor Corporation plans to have a car assembly plant, which will create more new jobs for the state, in operation by 1988 in Flat Rock, Michigan. The expansion of these auto plants should send welcome ripples throughout the region as related industries, including auto parts, chemicals, steel, and fabricated metals benefit from the increase in automobile production.

Prospects for steel manufacturing have increased as mini-mills boost output and productivity levels, but industry employment remains depressed. Another hard-hit industry is machine tools, but orders are expected to pick up this year in Wisconsin and Illinois. In order to make up for these lost jobs, the states are actively seeking foreign investors. In 1984, Japanese firms spent over $500 million in business ventures in Ohio. Rubbermaid Inc. of Wooster, Ohio, a producer of plastic housewares and industrial products, is setting up licensing agreements with Japan and other countries in order to boost sales. Unfortunately, contributing to the high unemployment rate are a number of industries which will see little or no growth. The food, and fabricated metals industries, which together comprise ten percent of the region's manufacturing jobs, are each expected to grow by barely 1.5 percent. Lower gasoline prices should boost Wisconsin's tourist industry but prospects for the farm sector are less optimistic. Its major product – milk – remains in excess supply and federal programs to support milk prices are scheduled to be cut.

The bright spot in the region lies in "Automation Alley," the Detroit-Ann Arbor corridor, which is on its way to becoming the robotics industries' equivalent of Silicon Valley. Of the estimated 60 robotics companies in existence, many operate out of this area. The rising fortunes of this sector should boost the earnings of related industries such as software companies, building vision sensors, and engineering services. Ohio is also participating in the robot revolution, with the recent joint venture between General Motors Corporation and Japan's Fanuc Ltd. and the well-established operations of Cincinnati Milicron.

A healthier economy is a safe prediction for this region. Part of the answer to the region's economic difficulties must be, over the long run, an increase in manufacturing productivity and a stronger competitive position *vis-a-vis* foreign producers. Since the region exports a large proportion of its manufactured goods, the weak recovery in our trading partners, combined with the strong dollar, have depressed foreign demand.

East South Central

Alabama, Kentucky, Mississippi, Tennessee

The East South Central region's economic outlook differs sharply among individual states and sectors. After surging forward early in 1984, the region's economy slackened in the summer when rising interest rates quickly depressed residential housing sales and construction activity. In response to lower demand, the region's lumber producing sector closed down a significant portion of its operations. At 8.3 percent, the region's unemployment rate is the highest in the nation. And, the region has the lowest hourly pay in the nation. Mississippi's economy lags the region's recovery, with unemployment standing at 9.3 percent.

The area's manufacturing activity depends heavily on the auto and housing sectors. Defense-related manufacturing, especially electrical and electronic machinery and equipment, should exhibit solid growth as should the region's paper manufacturing industry. However, the apparel and textile industries, especially in Alabama and Mississippi, have undergone a dismal year because of keen competition from imported products.

But, the textile industry is not the only sector troubled by intense foreign competition. The region's agricultural sector has also been beset by reductions in foreign demand. Low prices for farm products, heavy indebtedness, and persistently high credit costs remain major hurdles facing regional agriculture producers. The area's worst suffering industry is shipping, which may lose over four percent of total sales volume this year. In addition, the region's energy producing sector also remains depressed. The worldwide market for petroleum and natural gas is facing excess supply, depressed prices, and abundant capacity. Although some producers have slashed output to shore up prices, regional production of oil and gas cannot rebound until global market conditions improve.

Recently, General Motors Corporation picked the tiny town of Spring Hill, Tennessee for its $3.5 billion industrial complex to manufacture the Saturn – a venture that will create nearly 30,000 auto-related jobs within the state. GM joins Nissan Motor Company Ltd., Tabuchi Electric Co. of America, Bridgestone Tire Manufacturing of USA Inc., and a host of other Japanese and American companies that are making Tennessee an industrial mecca.

Kentucky, for years dependent on steel and coal, is undergoing an important transformation. Pike County – one of the state's fastest growing regions – is in the midst of one the biggest reconstruction projects ever undertaken in the nation, in an effort to provide more land for development. The state has also turned to the movie and television business in order to boost the economy; last year, film producers spent over $6 million on location in the state.

In sum, moderate economic growth is expected for the region this year. Not all sectors of the region's economy will participate in this growth but construction, services, and manufacturing of auto parts, building materials,

defense equipment and paper should enjoy a good year. A recovery in exports will also mean expanding trade for the port cities of Alabama and Mississippi and their goods – chemicals, coal, rubber, and forest products.

West South Central

Arkansas, Louisiana, Oklahoma, Texas

Growth in the West South Central region will be modest this year as a result of the weakness stemming from the low demand for petroleum and petroleum-related products. With total employment rising slower than population growth, the unemployment rate actually increased by one percentage point to 7.9 percent this year. Both Arkansas and Oklahoma have unemployment rates above the national average and Louisiana's stands at 11 percent. However, the region's prospects are looking more favorable this year. According to the National Planning Association, Houston, Texas, expected to create over 1.2 million jobs by the year 2000, was singled out as the number one job generator in the country.

A tremendous construction boom in the region has now turned sour, with new home sales running 29 percent lower than in 1984. Though office construction lags in Texas, there are signs of new activity. The 20 percent vacancy rate in Houston shows signs of shrinking as office-leasing activity picks up. In durable manufacturing, growth should be seen in machinery, instruments, fabricated metals, and aerospace equipment which reflect the effects of increased government defense spending in the region. The government remains the aerospace industry's largest customer, accounting for approximately 70 percent of all new orders in 1984. As in other parts of the U.S., the region's strongest performers are defense and electronics industries. E-Systems, a Dallas defense electronics company, reported a record $1.1 billion backlog in orders near the end of 1984.

Both Louisiana and Texas have large percentages of their manufacturing output coming from industrial chemicals, which are expected to show strong growth this year. Texas produced goods and services worth about 7.5 percent of the nation's gross national product last year. Twenty-two percent of what the state produces is tied to energy and petrochemicals, making Texas five times more dependent on the oil and gas business than the country as a whole. Mining and extraction employment will continue to fall for the next few years, reflecting continued overcapacity for oil and gas drilling. Although Texas is expected to increase drilling activity, only token increases in demand for oil, gas, coal, and electricity will occur this year.

Louisiana's disappointing economic performance is linked to weaknesses in the energy, petrochemical and international trade sectors, as well as to a lower than expected boost from the World's Fair in New Orleans, which left a $120 million debt. However, growth can be seen in the Lake Charles area, currently competing for $100 million worth of construction contracts, which would create over 3,000 new jobs. Producers of wood products, such as Pacific Simpson, have reopened their mills in order to compete with foreign suppliers in the area of low-cost substitutes for plywood.

In Arkansas, officials are encouraged by the increase in nonenergy manufacturing firms, which have created 25,000 new factory jobs in the past two years. In Oklahoma, oilfield equipment manufacturing remains weak and the financial stress of the farm sector continues to put a damper on the economy. However, automobile production contributed a great deal to the state's manufacturing growth. With the exception of Texas, the fastest growing state in the region, the South Central states have been struggling to keep pace with the national economy. Indications are that while growth will be slow, it will be steady.

West North Central

Iowa, Kansas, Minnesota, Missouri, Nebraska, North Dakota, South Dakota

Despite its increasingly diverse industrial base, the economy of the West North Central region continues to be dominated by agriculture. Farmers in the nation's heartland expect another year of low prices, excess production, mounting debts, and weak foreign demand. Even a big drop in the exchange value of the dollar would come too late to help agriculture in 1985. Of the major groups of wholesale food products, only fruit and vegetable prices rose over the last year. Prices of commodities produced in this region, including wheat, corn, milk, cattle, hogs, and poultry, have declined drastically, some by as much as 20 percent. Iowa, whose economy is very dependent on farming, had a 7.3 percent unemployment rate as of May 1985 – an increase from last year of 0.5 percentage points. Although wheat and beef prices may increase slightly this year, major international competitors with the region are Argentina and Canada, whose currencies have declined relative to the dollar.

In this atmosphere, farmland values continue to drop. The Federal Reserve Bank of Kansas City reports that land in some areas is selling for less than $1,000 per acre for the first time since 1978. Since 1981, farmland value in South Dakota has dropped by as much as 19 percent while in Nebraska it has fallen by 35 percent. Farm debts in South Dakota average about $144,000 and the state's debt-to-asset ratio of 29.5 percent is second highest in the U.S., behind Nebraska. An estimated 4,500 of the state's 36,000 farms are going under; 5,000 have failed in the last five years.

Naturally, these farm bankruptcies have had a debilitating effect on farm equipment and supply companies and have forced several bank closures. Tractor

sales declined about four percent last year and sales of combines, fell about 11 percent. Deere and Company, a farm equipment manufacturer, is laying off over 9,000 workers, while Allis-Chalmers laid off 530 workers at Independence, Missouri when it temporarily closed its combine plant. Caterpillar Tractor has also laid off workers in Illinois and Iowa. Companies, specializing in machinery for oil, construction, and farming equipment industries are in for a rough time this year.

However, gains in other sectors should boost activity in the area as nonfarm industries begin to account for a greater share of the region's output. Already, nonelectrical machinery – an industry group expected to sustain rates of growth over five percent this year – comprises over 15 percent of the region's manufacturing output. In addition, demand from the auto and defense industries for all types of machinery is expected to remain strong. In the high technology area, American Telemarketing Corporation and MidAmerica Long Distance Company started operations last year in Missouri, adding 2,200 new jobs to the economy. Construction, and automobile and aircraft plants operating in Missouri and Kansas provided the major impetus to those states' economies. Minnesota and South Dakota, with banking and high technology industries, led the region in job growth of about five percent last year. Nebraska, Missouri, and Kansas trailed close behind. Although the outlook for the region is for lower growth, it should be more manageable and more likely to guarantee healthy economies in the future.

Mountain

Arizona, Colorado, Idaho, Montana, Nevada, New Mexico, Utah, Wyoming

Although the Mountain region's population density per square mile is low, dramatic demographic shifts are altering this as growth continues to advance. In fact, only the South Central states are growing faster. The unemployment rate stands at 6.8 percent, and total employment is expected to increase by three percent this year in the service and high-tech areas.

As long as oil prices remain under pressure and natural gas is abundant, the region's huge energy industries are likely to remain stagnant. As in Montana, Wyoming's oil, gas, and coal industries suffered reversals that have depressed employment in the trade and service support areas as well. Mountain area states, though traditionally heavily dependent on resource-extraction industries such as oil, coal, lumber, and mining are finding greater shares of their income coming from high technology sectors such as defense, computer and instrument industries. Arizona and Colorado, in particular, are now deriving over one-third of their manufacturing income from electronic, electrical and computer-related products, telecommunications, instrumentation and other high technology items. Indeed, about 1,300 high-tech companies have relocated to Denver in recent years. For example, Sperry Corporation is building a $13 million facility in Pueblo, Colorado, to make navigational computers for the military. Moreover, various companies are doing work for the $1.2 billion Consolidated Space Operations Center to be built at Colorado Springs. Such companies as Denver Aerospace, Martin Marietta, Brown Disc Manufacturing in Colorado and Intel in New Mexico are expanding their operations and the employment opportunities for the region as a whole.

In New Mexico, uranium mining was an important source of economic stability, but now the largest uranium employer, Kerr-McGee Corporation, is closing down its operations. Industry analysts claim that inflation, government regulation, overseas competition, and opposition to nuclear power were responsible for the downturn. Meanwhile, defense-related research keeps the economy strong. Almost three billion dollars are being spent each year in basic and applied research in the state, employing 30,000 people. And, even as Congress debates the "Star Wars" weapons-in-space program, the research into S.D.I. is underway. Another growth sector within the state has been the relocation of several branch plants of established electronics firms such as Intel, Motorola, General Electric and others, which have provided employment growth in excess of 20 percent over the past year. The combined effect of these activities has spurred increases in construction, services, and trade industries for substantial gains in employment.

Construction activity throughout the region is booming. In Utah, construction activity is 14 percent above levels reached in 1984 and in Arizona it is up 18 percent. Lumber and other construction-related industries in Montana and Idaho should, therefore, fare well this year.

The outlook for the nonferrous metals industry hinges on the continuing expansion in the auto and housing industries. The aluminum industry, which is beset with overcapacity and tough foreign competition, is now concentrating efforts on developing more sophisticated aluminum products and is in the process of diversifying into non-aluminum businesses. Foreign overproduction in copper mining has forced mine closings in Arizona, Utah, New Mexico, and Montana. Agriculture is bleak too, with wheat and beef producers continuing to be crippled by low prices, high interest rates and a strong dollar.

Pacific

Alaska, California, Hawaii, Oregon, Washington

No region in the country enjoys a better base for solid, long term expansion than the Pacific. From California to Washington, the region is banking on continued growth in electronics, aerospace and defense industries. The region also produces large quantities of oil, lumber, food, nonelectrical machinery, and instruments. The results of this highly positive industrial makeup are instantly ap-

parent: the Pacific has the second highest rate of population growth, the highest job creation rate, and retail sales are among the strongest in the nation.

Oregon, best known for its lumber industry, has recently acquired the business of several Japanese electronic companies, which created over 13,900 jobs last year. As a result, the state will soon produce 25 percent of the world's silicone wafers. NEC Corporation, a Japanese electronics company, is building a $25 million factory for the production of fiber optics equipment; the West German-owned Wacker Siltronic Corporation has decided to build the world's largest polysilicon plant in the state; and National Semiconductor is laying the plans for a chip factory and an R&D facility in Portland. Oregon's lumber and wood processing plants may never return to previous operating levels, but electronics and electronics support businesses will contribute to the state's prosperity.

Washington's aluminum, wood-processing, and agricultural industries are all suffering from stiff foreign competition and oversupply. But the state has managed to keep its head above water by diversifying its economic base and welcoming over 350 electronics firms to the area, which contributed to the creation of 38,900 new jobs. A major source of manufacturing jobs in the region is the aerospace industry in Boeing's Seattle-area installations. Boeing increased its employment by 6,800 workers last year and if the company wins the contract to design the first manned space platform, an additional 1,500 jobs will be created.

Prospects for southern California's aircraft industry are also good. Long Beach-based Douglas Aircraft is benefiting from an American Airlines order for 67 MD-80 aircraft and a $438 million contract to develop the T-45, a new advanced Navy trainer jet. Rockwell International will hire 2,000 workers in the area, and Northrop Aircraft is also on the upswing. Defense-related expenditures will also contribute to the growth of electronics companies in Northern California.

Though growth in office-related industries is expected to be slow this year, computers still remain a strong sector. The overall gain of semiconductors and computers will be in the eight percent to ten percent range – half the pace of the last few years. For years, the famous high-tech Silicon Valley area provided jobs for about 2.5 million workers, but this year, signs of a slowdown are evident as electronics companies are reeling as a consequence of saturated markets and mushrooming foreign competition. Apple Computer laid off a fifth of its work force in a reorganization; Hewlett-Packard, facing unusually weak orders, mothballed most of its facilities for one to three days a month this summer; and Intel Corporation, one of Silicon Valley's most innovative semiconductor companies, is expected to lay off more than 1,000 employees. After phenomenal annual growth rates of over 20 percent, it is hardly surprising to see the pace of the computer industry slowing down.

The prospects for home building are the key to recovery of the vital timber industry in the region. Even as housing starts have turned favorable, market penetration by imports of Canadian lumber and the emergence of the Southern states as major suppliers of wood products, have hurt the Pacific Northwest. And, in Puget Sound, Washington, the shipbuilding industry is also in danger of losing work, with the Naval Shipyard trimming jobs as a part of a Navy cost reduction program.

The biggest sore spot on the region's horizon is farming. Hardest hit are rice and grape growers in California. But, fruit and vegetable producers in Hawaii and California are still commanding rising prices and should outperform other sectors. Despite soft oil prices, employment on the North Slope of Alaska should increase by seven percent because of drilling by Sohio and Arco at Prudhoe Bay. Tourism is still strong in Alaska as well as in Hawaii. With an eye to the future, all these states are striving to improve their business climate and economic growth in the region should remain strong.

DEVELOPING COUNTRY DEBT: WE ARE NOT OUT OF THE WOODS YET

by

Graciela Testa-Ortiz

The developing country debt problem, which erupted in 1982, has been successfully managed by most measures. Despite periodic rumblings (which recently intensified when Peru's newly elected president announced a ceiling on debt service payments and Fidel Castro hosted a conference on the issue urging the Latin American debtors to "cut out the cancer of debt"), the crisis atmosphere that prevailed three years ago has waned.

This article examines the current situation and the prospects for restoring growth and improving the debt service capability of the indebted developing countries. It finds that while progress so far seems to be encouraging, the resolution of the debt quandary will be a slow process, and that the problem is likely to remain with us at least through the end of the decade. Success in continuing to manage, and finally resolving it, depends significantly on the international economic environment during the next five years. Even more importantly, however, it depends on the ability of the indebted nations to affect the necessary policy adjustments which will ensure an environment of economic growth and political stability.

The Crisis: Recent Developments

For the developing countries, the external payments crisis was precipitated by the global economic develop-

ments of 1979-1982, including: (1) the second increase in oil prices; (2) the recessions of 1980–1982; (3) low commodity prices; and (4) rising interest rates. This combination of developments sharply reduced the volume and value of developing country exports while at the same time increased borrowing needs and debt service payments.

The worldwide economic recovery in 1983-1984 contributed to a marked improvement in the situation and defused the crisis atmosphere prevalent in 1982. World economic output rose by 4.3 percent last year, comparable to the average annual rate of growth that characterized the 1967-1976 period. More importantly, while output growth in the developing nations (3.7 percent), was considerably below the 6 percent average achieved in 1967-1976, it nevertheless represented a significant turnaround from the lackluster performance of the previous three years. Although the bulk of this improvement was largely the result of continued strong growth in the Asian nations, the economies of the major borrowers—Argentina, Brazil, Indonesia, Korea, Mexico, the Philippines, and Venezuela—enjoyed a 3 percent rise in output last year, following 3 years of very meager growth which included a recession in 1983. Moreover, those countries which recently experienced debt-servicing difficulties (namely, those which incurred external payments arrears or have had to reschedule their debt since 1981), also enjoyed a substantial turnaround in 1984 following two years of recession (see Table 1).

However, because the world recovery was not accompanied by a rise in commodity prices, the indebted nations did not benefit from the increase in foreign demand as much as they otherwise would have. The impact of weak commodity prices is reflected in the fact that, although the major borrowers enjoyed a 10 percent increase in the *volume* of their exports in 1984, the rise was nil in *value* terms. The continued weakness in commodity prices is not only associated with the dollar's appreciation since 1980, but also with technological improvements. For example, plastics are now being extensively used in construction where copper tubing was used in the past. This has resulted in a falloff in demand for copper despite the economic recovery. Another factor contributing to the current weakness in commodity prices is the increase in supply which resulted following the price boom of the mid-1970s.

The impact of external economic conditions differed in magnitude from country to country. For instance, the 1979 increase in oil prices is generally seen as a negative shock; however, this development was assuredly a plus for the oil exporting debtors. In some cases, it was a positive

TABLE 1
SELECTED INDICATORS OF RECENT ECONOMIC ACTIVITY

	1980	1981	1982	1983	1984
REAL GDP (% CH)					
Indebted Devoping Countries [a]	4.4	3.1	2.0	1.8	3.9
Major Borrowers [b]	4.7	1.8	0.4	−1.2	3.0
Countries with recent debt-serving problems [c]	3.9	1.1	−0.1	−1.9	2.0
FISCAL BALANCE (% OF GDP)					
Indebted Developing Countries	−2.9	−4.0	−4.9	−4.7	−3.8
Major Borrowers	−0.3	−3.0	−4.0	−3.1	−1.4
Countries with recent debt-servicing problems	−1.9	−3.8	−4.4	−4.0	−2.4
CURRENT ACCOUNT (US $B)					
Indebted Developing Countries	−77.0	−112.6	−102.9	−59.4	−37.9
Major Borrowers	−26.5	−35.7	−39.8	−10.9	−1.5
Countries with recent debt-servicing problems	−47.7	−66.7	−61.7	−25.6	−14.7
EXTERNAL DEBT (% OF EXPORTS)					
Indebted Developing Countries	110.4	123.3	148.0	157.9	151.3
Major Borrowers	175.2	187.4	240.9	254.9	236.6
Countries with recent debt-servicing problems	167.1	194.5	246.0	268.1	256.8
DEBT SERVICE (% OF EXPORTS)					
Indebted Developing Countries	17.3	20.9	24.6	22.2	22.5
Major Borrowers	29.8	35.4	44.3	35.8	35.1
Countries with recent debt-servicing problems	26.9	33.8	41.6	36.2	36.6

SOURCE: *World Economic Outlook*, International Monetary Fund, (4/85)

[a] Indebeted developing countries include all developing countries except the eight Middle Eastern oil exporters.

[b] Major borrowers are: Argentina, Brazil, Indonesia, Korea, Mexico, Philippines, and Venezuela.

[c] Countries that have experienced debt-servicing difficulties are those countries which incurred external payments arrears during 1981–1983 or rescheduled their debt during 1981–1984.

development of such magnitude that it offset the negative impact of weak foreign demand and high interest rates. Not surprisingly, therefore, the increase in oil prices had a positive impact on Mexico and Venezuela. Moreover, it did not create hardship for Argentina, a country which is energy self-sufficient (see Table 2).

In many cases, more than the shocks themselves, it was the domestic policy responses to the shocks which ultimately determined the extent of the debt problem faced. For example, the appropriate response to a rising oil import bill would have been an attempt to increase the international competitiveness of domestic products through, among other things, the maintenance of realistic exchange rates. This, in turn, would have buoyed exports, offsetting the deterioration in the balance of payments on current account (the current account represents flows of goods, services, and private transfers), occasioned by the increased cost of oil.

Table 2 compares the size of the external shock to the change in the current account and to capital exports in the seven largest Latin American countries. The data shows that none of the countries which experienced negative shocks completely offset their impact. Brazil made the greatest effort at adjustment as evidenced by the fact that its current account deteriorated by only $24 billion while the external shocks amounted to $49 billion. In Chile and Argentina, the effects of a worsening external environment were exacerbated by internal policies which resulted in a mounting current account deficit. The current account of both of these countries deteriorated by more than the negative shock. The outcome in the countries which experienced a net improvement due to the increases in oil prices is even more disappointing. In the case of Venezuela, although the current account improved by about as much as the positive shock, this was offset by a cumulative capital flight of $13 billion between 1979 and 1982. And despite enjoying a $12 billion positive shock, Mexico allowed its current account to deteriorate by almost $19 billion. This was further compounded by a $15 billion capital flight.

Signs of Success...?

The International Monetary Fund (IMF) has played an important role in managing the debt crisis. In addition to providing bridge loans, it has recommended the enactment of austere macroeconomic policies in the indebted nations. These policies should be geared toward improving debt service ability by restoring growth and reducing the need for future borrowing. Austerity measures, however, can result in lower economic growth and thus, be extremely counter-productive in that they exacerbate debt servicing problems. In general, the goal of these policies is to reduce both the size of the government sector deficit and external imbalances. By these measures, the strategy appears to have succeeded. Table 1 shows that both central government and current account deficits have indeed declined.

However, reliance on the deficits as a measure of improvement fails to highlight how the so-called improvement has been accomplished. Government deficits can be reduced through declines in spending or increases in revenues. Declines in government spending reduce the level of government intrusion in the productive process and improve an economy's productive efficiency. However, raising revenues through increased taxation further reduces incentives to work, save, and invest. Thus, *how* the fiscal deficit is reduced, not just that a reduction has been accomplished, is of utmost importance. A reduction in the deficit that is accomplished through increased taxation will reduce productive efficiency, lower overall economic growth and worsen, not improve, a country's ability to service its debt. Bear in mind that many of the countries now experiencing difficulties already have high tax burdens. The top personal income tax rate in most of the Latin American countries

TABLE 2
SOURCES, MAGNITUDE AND EXTENT OF ADJUSTMENT/DISADJUSTMENT TO EXTERNAL SHOCKS FOR SEVEN LATIN AMERICAN COUNTRIES
(billions of dollars, 1979–1982)

	Terms of Trade		High Real Interest	Low Export		Current Account	Capital
Country	All Trade	Oil	Rates	Demand	Total	Change [a]	Export [b]
Colombia	−4.3	−0.9	−0.9	−1.6	−6.8	−6.6	0.7
Brazil	−31.7	−17.9	−8.9	−7.9	−48.5	−23.6	−2.0
Chile	−1.9	−1.4	−1.5	−1.5	−4.8	−8.5	1.0
Argentina	−6.2	−0.6	−3.7	−3.6	−13.4	−18.9	−14.3
Peru	2.3	1.2	−0.8	−1.1	0.4	1.3	1.3
Mexico	22.5	21.0	−8.4	−2.4	11.7	−18.7	−15.2
Venezuela	24.0	29.4	−4.6	−0.3	19.1	19.5	−13.0

SOURCE: Enders and Mattione, *Latin America: The Crisis of Debt and Growth*, Brookings Institution, 1984.

[a] Adjusted for inflation.
[b] A minus sign denotes capital flight, i.e., an unfavorable movement in the relevant items of the capital account.

Note: A minus sign indicates an unfavorable shock. Totals are unadjusted for dollar inflation.

is over 40 percent, and is as high as 65 percent in Peru, and 70 percent in the Dominican Republic and Uruguay.

There is some evidence that the decline in fiscal deficits has, in fact, been accomplished through increased taxation. In Mexico, touted as a model of compliance with the IMF, the budget deficit was reduced through increases in taxes (sales taxes, for instance, were increased to 15 percent), and increases in the prices of goods and services produced by the government. Meanwhile, the already bloated government bureaucracy rose by 281,000 employees, more than the increase which took place in the previous six years. The same is true in Argentina where measures to reduce the government deficit have included increases in taxes on exports of wheat, corn, and soybeans. While these polices might raise government revenues, they will exacerbate trade deficits.

The extraordinary reductions in current account deficits of the indebted countries are also pointed to as an example of improvement. The major borrowers reduced their collective current account deficit by $38 billion in the past two years, from $39.8 billion in 1982 to only $1.5 billion in 1984 (see Table 1).

Unfortunately, this performance did not translate into a major improvement in the debt service ability of the indebted nations. There are three main measures of a nation's ability to repay its debt: the ratio of debt to total output (or gross domestic product), the ratio of debt to exports of goods and services, and the ratio of debt service payments (i.e., interest plus amortization), to exports of goods and services. Of these three measures, the last two are the most relevant since it is a nation's exports which allow it to earn the foreign exchange necessary to service and eventually repay, the debt. Thus, a nation with a vibrant and growing export sector can carry, without major difficulties, a debt burden (as measured by the ratio of debt to GDP), which another nation, with the same debt to GDP ratio but a lower rate of growth in exports may not be able to.

Table 1 shows that for all the indebted developing countries, debt service payments as a percent of exports of goods and services averaged 22.5 percent in 1984 compared to 24.6 percent in 1982. However, these overall figures hide the disparities between groups of debtors. While the Latin American and Caribbean countries shared in the improvement, the poorer African nations did not. Moreover, while the total external debt of the indebted developing countries has been rising at a slower rate since 1980 (11.6 percent per year between 1980 and 1984, compared to 23.4 percent per annum between 1977 and 1980), the improvement in these nations' ability to service their debt has not been impressive. As a percentage of exports of goods and services, the external debt of the major borrowers averaged 237 percent last year, an improvement over 1983 but still close to the 1982 average of 241 percent.

This outcome reflects a negative development which is hidden in the data for the current account. Namely, that the improvement in the current account has resulted from a substantial retrenchment in imports and, generally, has not come about through an increase in exports and thereby, has not resulted in an improvement in debt service ability. In the case of certain major borrowers, particularly those in Latin America, improvements in trade balances appear to have peaked approximately a year ago. In these countries, improved economic performance in 1984 and 1985 has been accompanied by a pickup in imports, while, with the exception of Brazil and Colombia, 1984 export growth remained below the rates achieved in 1964-73 and 1974-84. The data available so far for 1985 is even more disappointing (see Table 3).

TABLE 3
GROWTH IN EXPORTS
LATIN AMERICA vs. ASIA
(percent)

	1964-73	1974-84	1984	1985 [a]
Latin America				
Argentina	9.1	8.6	3.7	-13.4
Brazil	16.0	14.3	23.3	-6.0
Chile	9.0	10.4	-4.6	-5.3
Colombia	7.9	10.7	19.9	14.5
Ecuador	16.0	14.4	5.3	19.6
Mexico	8.8	23.4	7.8	-11.1
Peru	7.2	9.9	4.4	3.3
Venezuela	7.3	11.8	7.8	5.4
Asia				
Hong Kong	19.2	16.9	28.1	
Indonesia	16.5	19.8	10.8	
Korea	43.5	21.6	13.3	
Malaysia	10.8	16.6	17.3	
Philippines	11.2	9.8	7.9	
Singapore	12.4	18.8	10.9	
Thailand	13.0	15.2	16.3	

SOURCE: Morgan Guaranty Bank

[a] 1985 year to date, percent change from same period a year earlier. Jan-Apr: Brazil; Jan-Mar: Argentina, Chile, Ecuador, Mexico; Nov 84-Jan 85: Peru; Oct-Dec 84: Venezuela; Sept-Nov 84: Colombia.

Foreign Borrowing: The Key to Economic Development or a Recipe for Disaster?

The debt crisis has called into question the viability of reliance on external funds as a strategy for economic development. Recent experience has shown, quite dramatically, the potential for disaster lurking in excessive borrowing. Or has it? Are the difficulties encountered by the countries experiencing debt servicing problems the result of too much borrowing, of external factors beyond their control, or are other factors; namely, internal policy decisions, at work?

External borrowing can provide a developing nation with the funds necessary to pursue economic growth and concomitant increases in its standard of living. It can also

aid an economy to adjust to temporary external shocks. The data shows that countries with similar debt to total output ratios may have entirely different debt service burdens, and further, that high ratios of debt to total output do not necessarily imply debt servicing difficulties. The factors which determine whether external borrowing is an asset or whether it eventually becomes a serious disadvantage are the domestic policies which accompany the increase in debt.

It is not a coincidence that the countries experiencing the most serious debt servicing difficulties are concentrated in Latin America, a region which has traditionally relied on a strategy of industrialization through import substitution behind trade barriers. On the other hand, market-oriented economies such as those of the Asian developing countries, have not experienced the same problems. For instance, both Malaysia and Chile have comparable (public) debt to output ratios—38.6 percent and 39.2 percent, respectively. However, the vast difference in their economic performance and their ability to service the same debt burden is clearly evident from their respective ratios of debt service to exports of goods and services. Chile's debt service payments reached 18.3 percent of exports in 1983 while Malaysia's was only 5.9 percent. Tables 3 and 4 compare the economic performance, in terms of output and export growth, and the debt burdens of Latin America and Asia. It shows that while the debt to GDP burden is, in some cases, comparable, the growth in total output and exports has been more vigorous in the Asian developing countries. As a result, the debt service burden of this group is much lower.

TABLE 4
FOREIGN BORROWING
AND ECONOMIC DEVELOPMENT
LATIN AMERICA vs. ASIA

	Real GDP Growth Rates			Ratio of Debt to	Ratio of Debt Service
	1964-73	1974-84	1984	GDP [a]	to Exports [b]
Latin America				37.4	24.4
Argentina	4.0	0.8	2.0	32.1	24.0
Brazil	7.4	4.5	4.5	29.3	28.7
Chile	2.9	1.7	5.6	39.2	18.3
Colombia	6.2	3.8	2.5	18.3	21.3
Ecuador	9.5	4.5	2.2	63.0	32.5
Mexico	7.4	4.7	3.5	49.1	35.9
Peru	5.1	1.3	4.7	48.1	19.6
Venezuela	5.2	2.1	−1.7	19.8	15.0
Asia				20.7	9.8
Hong Kong	8.2*	8.1	9.0	0.8	na
Indonesia	11.8	6.5	4.6	28.9	12.8
Korea	10.8	7.5	7.5	na	12.3
Malaysia	7.1	7.2	7.3	38.6	5.9
Philippines	5.3	4.1	−5.5	30.4	15.4
Singapore	11.9	7.9	8.5	7.6	1.3
Thailand	7.6	6.6	6.0	18.0	11.3

SOURCE: Morgan Guaranty Bank and World Bank

na: not available
*1967-73

[a] Public debt as a percent of gross domestic product (1983 data).
[b] Public debt service payments as a percent of exports of goods and services.

Despite the deterioration of international economic conditions in 1979-1982, the majority of the developing countries have been able to continue to service their debt without interruption. An important characteristic of the nations which have not experienced financing problems is the application to which the borrowed funds are put. If the funds are utilized to finance an investment project which will ultimately improve the country's capacity to export, then the debt will not become as onerous a burden as if it is used to fund current consumption or large public projects which contribute little to export growth or real economic growth. In the first instance, both the debt to output and the debt to exports ratios would improve. In the latter instance, the debt to output ratio might improve, but the debt to exports ratio will deteriorate. This has been the experience of many African and Latin American countries which have undertaken large-scale investment projects in energy development, heavy industry and infrastructure which had low rates of return and were generally inefficient and uncompetitive.

Another important difference between the domestic policies of nations that experience problems and those that do not appears to lie with the degree of economic flexibility and the speed with which these nations have adjusted to external shocks. These, in turn, seem to be related to the extent to which the economy in question relies on the interplay of free market forces and the relative extent to which it is open to foreign trade and competition.

Domestic Policies of Problem Debtors

By and large, the Latin American nations relied on external borrowing to *avoid* rather than to facilitate the economic adjustments necessary following the first oil price shock. For the most part, these countries rejected the necessary pain of adjustment and followed a growth strategy based on import substitution and accumulation of foreign debt to deal with external imbalances. While the domestic policies which underlie the emergence of the debt crisis vary, the following are common characteristics: (1) expansionary fiscal and monetary policies resulting in galloping inflation; (2) overvalued exchange rates which reduced the competitiveness of exports and induced capital flight; and (3) increases in domestic investment not matched by increases in domestic savings.

These policies merit a more detailed discussion. Large central government deficits have resulted from a combination of excessive public sector investment and growing government consumption, as reflected in the large number of government enterprises. These are not limited to

the creation of economic and institutional infrastructure, which can be legitimately considered the central government's responsibility. It also includes such economic sectors as transportation, utilities, financing, insurance, communications, trade and manufacturing, and the exploitation of mineral resources. The proliferation of state enterprises is indeed, vast. For instance, the Brazilian government has varying degrees of ownership in over 400 productive enterprises, and public enterprises comprise 9 of the 10 largest firms in that country. A measure of the extent of government intrusion in the productive process in Argentina is reflected in the fact that, in 1982, there were approximately 1.6 million people employed by the public sector, accounting for 26 percent of total employment for that year. Public investment projects in Turkey totaled 3,000 in 1976 and rose to 9,000 in 1980.

The widespread existence of government monopolies not only contributes to the creation of vast bureaucracies, but also to the misallocation of scarce resources, and reduced productive efficiency, which, in turn, result in lower rates of economic growth and lower living standards. The inefficiency of some of the public investment projects is truly amazing. The Peruvian government, for example, recently constructed an oil pipeline; however, this pipeline is bigger than the capacity of the country's oil fields. Peru has also invested heavily in agriculture, but the sugar complexes constructed have a unit operating cost which is three to four times the world price for sugar.

The resulting government deficits are financed through a combination of high levels of taxation, foreign borrowing, and money creation. Expansive monetary policy to finance government deficits is a prime cause of the hyperinflation many of these nations are now suffering. The broad monetary aggregates in the indebted developing countries have increased at average annual rates in the 30 percent to 50 percent range since 1977. The countries experiencing debt servicing difficulties allowed the monetary aggregates to grow by 85 percent in 1984, compared to a 21 percent increase in the developing countries not experiencing major problems.

This combination of policies led to a crisis of confidence reflected in the magnitude of the capital flight. Large scale capital flight, which has placed tremendous pressures on the balance of payments of some countries, results when the expected returns of holding money abroad are higher (or safer), than they are at home. This occurs when overvalued currencies increase the risk of future depreciations; when inflation is high, reducing real rates of return on domestic investment; and when financial policies at home attempt to maintain interest rates lower than inflation. Between 1979 and 1982, capital flight amounted to 137 percent of gross capital inflows in Venezuela, 65 percent in Argentina, 48 percent in Mexico, and 27 percent in Uruguay.

Trade policies have also reduced economic efficiency and economic growth in these countries. Fomenting growth through import substitution has hampered exports since a large proportion of Latin American exports are dependent on foreign inputs, which were restricted by all manner of tariff and nontariff barriers. At the same time, taxes on exports have been relatively high, for no apparent reason other than the fact that this appears to be a particularly easy tax to collect. The combination of trade barriers and currency overvaluation reduces the competitiveness of Latin American exports. Furthermore, the types of industries which have surfaced behind the protective barriers of these countries are not in a position to take advantage of international markets. The lack of international competition in a sheltered domestic market is not conducive to the development of efficient industries which are able to compete internationally.

Compare the outcome of these policies to that of the policies instituted by India in response to the first oil price shock. India, a low-income country, already had a sizeable debt to output ratio in 1974 and was in recession at the time. Rather than postpone adjustment through borrowing, Indian policy makers chose to reduce the fiscal deficit through increased taxes and reduced spending, and to control inflation through tight monetary policy. Domestic energy prices were allowed to adjust quickly to international levels. By 1978 the adjustment process was complete, and India became a net international lender enjoying a current account surplus. In the early 1980s, India was able to resume a growth strategy based on liberalized import controls and increased investment incentives.

While Latin America has the largest concentration of reschedulers of any geographic region and counts its four largest economies among the seven major borrowers, it is not alone in its misery. Poland and Yugoslavia have faced similar problems, although Yugoslavia has avoided rescheduling, thanks to a massive rescue operation by its major creditors in 1983. The domestic policies of these two countries prior to the onset of severe financing difficulties are strikingly similar to that of the Latin Americans, as state planning and state enterprises are common characteristics.

In Poland, an ambitious modernization effort was considered a prerequisite for political stability. In order to achieve rapid growth, Poland needed massive infusions of Western capital and technology; thus, external financing began growing in the early 1970s. The growth strategy involved a reorientation of trade away from the Eastern bloc toward the industrial West. Up until 1975 the strategy worked well; however, major policy mistakes became apparent thereafter. In the late 1970s, as trade deficits widened, import restrictions seriously affected Poland's exports because, as is the case with many Latin American countries, a large percentage of export industries are vitally dependent on foreign inputs. Yugoslavia has shared with the Latin American countries an emphasis on import substitution and currency overvaluation, as well as a dependence on imported intermediate

goods. During the 1970s, Yugoslav exports shifted toward the Eastern bloc countries, while a large share of merchandise imports still came from the West, resulting in a widening bilateral trade deficit. Between 1973 and 1979 strong increases in domestic demand, led by growth in fixed investment, further diverted resources away from the export sector and placed additional pressure on the external account.

Early efforts at currency depreciation, in order to increase export competitiveness, which was being eroded by rising rates of domestic inflation, had the same results in Yugoslavia as they did in the Latin American economies. While the initial response was positive, depreciation eventually proved not to be enough as inflation continued to rise faster. The benefit of currency depreciation lies in the fact that it increases the competitiveness of domestic goods by making their price relatively cheaper in international markets. However, rising domestic inflation, by increasing domestic costs, can significantly erode international competitiveness, particularly if domestic currency depreciation is not used to offset this effect.

Finally, the structure of the foreign debt being acquired by the nations which are now experiencing the greatest difficulties has changed considerably and contributed to current problems. Two characteristics of the debt structure—the interest rate and the maturity—placed these nations in highly vulnerable positions. Ideally, loan maturities should match those of the investment projects being funded, and which are expected to generate the necessary income to repay the debt. The increase in the proportion of short-term debt to total debt was, therefore, a clear recipe for disaster since the debt became due before the investments yielded the income with which to repay it. The proportion of debt incurred at floating interest rates also rose markedly. As a result, high nominal and real interest rates have significantly increased debt service burdens.

Managing the Debt and Restoring Growth

In spite of the decline in capital flows since 1981, the outstanding debt of the major borrowers reached $360 billion in 1984, compared to $129 in 1977. Moreover, total debt has risen, not fallen, over the past three years. What needs to be done to turn this situation around?

External Factors

The global economic environment during the next five years will play an important role in the eventual outcome of the debt problem. The ideal situation would include the following events: (1) strong and uninterrupted economic growth in the West; (2) declining interest rates; (3) strengthened commodity prices; (4) the industrial nations significantly open up their markets to developing country exports.

Analysts have attempted to quantify the impact of external economic conditions on economic growth and debt in the major debtor nations. Table 5 shows the sensitivity of economic performance in the major seven Latin American debtors to a positive external environment. A one percentage point increase in economic growth in the industrial nations would increase real GDP growth by 1.7 percentage points and reduce the debt by $15 billion by 1987.

TABLE 5
SENSITIVITY OF ECONOMIC PERFORMANCE TO EXTERNAL ECONOMIC CONDITIONS FOR SEVEN LATIN AMERICAN COUNTRIES 1983 TO 1987

Conditions	Debt [a]	Real GDP [b]	Debt to Exports Ratio [c]	Current Account Deficit [d]
Base Case	342.9	5.6	252.3	6.5
Increased Demand in OECD Countries	327.5	7.3	228.2	1.6
Decreased Interest Rates	331.2	6.4	244.2	4.5
Increased Oil Prices	334.1	6.0	237.3	4.0
Improved Terms of Trade	319.8	5.7	222.9	0.6

SOURCE: Enders & Mattione, *Latin America: The Crisis of Debt and Growth*, Brookings Institution, 1984.

[a] 1987 Foreign debt outstanding in billions of dollar.
[b] Growth (percent change) in real GDP between 1982 and 1987.
[c] 1987 Debt to exports ratio (percent).
[d] 1987 Current account deficit as a share of exports (percent).

Note: The base case reflects IMF stabilization programs, i.e., the countries are assumed to follow policies of fiscal and monetary restraint. The increased demand alternative assumes that growth in the industrial nations is one percentage point higher relative to the base. The decreased interest rates alternative assumes that interest rates are 100 basis points lower. The increased oil prices scenario assumes oil prices are ten percent higher. The improved terms of trade scenario assumes that the price of nonoil commodity exports is one percentage point higher.

Unfortunately, this rosy scenario is becoming increasingly unlikely. The U.S. economy is already halfway through its third year of expansion, and as can be expected at this stage of the economic cycle, growth is slowing. In spite of the fact that we anticipate U.S. economic performance will stage a comeback during the second half of 1985, it would be unrealistic to expect the very high rates of growth experienced during the first year and a half of recovery. A slowdown in U.S. economic growth, at least when compared to recent experience, would not be a cause for concern if growth in Europe and Japan were to pick up the slack. However, while Japan shows a great deal more vigor than the European nations, the likelihood of their combined economies staging a vigorous upturn is slim. Econometric evidence suggests that a rate of growth of 3 percent in the OECD nations is necessary in order for the debt problem of the developing countries to

remain manageable. Current OECD forecasts call for a 3.3 percent increase in 1985 and a 2.8 percent increase in 1986, barely enough to remain within the "manageable" threshold. Thus, assuming that there will not be a recession in the industrial nations over the next five years, the best that can be hoped for is the same rate of increase in demand for developing country exports as we are now experiencing. Thus the debt problem will be manageable, but not resolved.

The outlook for interest rates is slightly more optimistic. As measured by the London Interbank Offered Rate (LIBOR), interest rates have fallen by 400 basis points over the past year. For the Latin American nations, a sustained 100 basis point decline in interest rates would imply a 0.8 percentage point increase in economic growth and a $12 billion decrease in the debt by 1987 (see Table 5). However, commodity prices, and in particular oil prices, are expected to remain weak. While low oil prices are an unambigous plus for the industrial economies as well as for the oil-importing developing countries, the net impact of low oil prices on all the indebted countries is negative. Of the seven major borrowers, three (Indonesia, Mexico, and Venezuela) are oil exporters, and one (Argentina) is self-sufficient in energy. Therefore, continued weakness in oil prices will have a decidedly negative effect on the first three nations, and no significant impact on Argentina.

Domestic Policies

The external environment during the remainder of the decade can, at best, be expected to be moderately supportive to the developing countries. However, the problem will not be solved, future crises will not be avoided, and growth will not resume in the indebted nations unless their governments commit themselves to the types of policies which have been so successfully applied in Asia. Constancy and continuity in policy implementation are also imperative, as adjustment, of necessity, requires some short-term sacrifices. This has not been achieved in the Latin American nations. Although earlier efforts at liberalization did prove beneficial in terms of increasing the rate of growth in exports, they were short-lived, lasting only three years in Mexico and Argentina, four years in Chile, and six to seven years in Brazil and Colombia.

Econometric simulation studies and the experience of the Asian countries show that a major effort at stimulating growth through expanded exports, as opposed to an investment-led recovery, would yield the greatest benefits. Investment-led growth would not be very successful, particularly since capacity is already underutilized. Thus, there is little incentive to expand investment, especially if there are no signs of rising future domestic demand. Further, the large dependence on foreign inputs implies that increased investment would result in deteriorating trade balances and an increase, rather than a reduction, in the accumulation of debt. Once an export-led recovery is underway, however, a switch toward increased investment might be appropriate, especially to the extent that it can lead to additional production for export.

The Latin Americans allege that slow export growth, particularly in relation to the Asian performance is due to external factors related to their dependence on particular trading partners and products, and protectionism in the industrial West. The data, however, does not bear out this claim. In fact, for Latin America as a whole, exports to industrial countries account for 66 percent of total exports, not significantly different from the Asian experience where the comparable ratio is 63 percent. The major market for both groups of nations is the United States. As a result, market orientation does not explain their poor export performance. Protectionism in the industrial West did not place the Latin American economies at a greater disadvantage than that of the Asian developing countries. An IMF study shows that protectionism has had a greater negative effect on Asian exports than on Latin American exports.

Their dependence on commodity exports does explain relatively more of their lackluster export growth because commodity prices have remained weak. However, with the exception of Brazil, the Latin American nations did not embark on a concerted effort of promoting nontraditional exports. As a result, exports of manufacturers comprised only 16 percent of total exports in 1980-82 compared to the Asian countries' 54 percent ratio.

Spiraling inflation in Latin America is the most painful evidence of the failure of macroeconomic policies. Fiscal and monetary policies should be focused toward reigning in inflation and promoting exports. To that end, a long, hard look should be given to government spending policies. Privatization of government enterprises would go a long way toward reducing government spending and improving efficiency. Reductions in government subsidies would not only help reign in government spending.

High tariff and nontariff barriers have also contributed to the proliferation of inefficiencies as well as powerful interest groups. Even more damaging to efforts at raising foreign exchange and diversifying exports are the relatively high levies on exports. These types of policies only exacerbate trade deficits and offset benefits derived from exchange rate adjustments, thus reducing international competitiveness. Moreover, a few countries (e.g. Chile), fail to provide duty-free imports of intermediate products to exporters, further hindering export growth. In fact, according to a recent study by Morgan Guaranty Bank, protective barriers sheltering local economies in much of Latin America stand higher today than before the onset of the debt crisis.

A prerequisite for a strong export performance is maintenance of a realistic exchange rate. Unfortunately, in many indebted developing countries, particularly in Latin America, a strong currency is a matter of national

pride rather than a policy tool to promote exports, and thus, economic growth. Overvalued currencies distort, and in some cases, have offset the impact of liberalized trade policies. As a result, production becomes biased in favor of domestic markets, imports rise, and capital flight is encouraged. Many nations resort to credit and exchange controls in order to deal with the capital flight problem when the appropriate, market-clearing policy would be currency depreciation. Such policies only ensure that capital will not be repatriated. The problem of capital flight can only be solved through the maintenance of realistic exchange rates, the removal of credit controls so that rates of return on domestic currency investments will keep pace with inflation, and assurances that such funds will not be subject to confiscation and freezes, or unduly taxed. The issue of capital flight begs the question of the quality of economic growth being purchased by increased indebtedness. It also raises the issue of the advisability of international financing and rescue efforts to increase the flow of capital from abroad when national citizens are removing their assets from the country.

A new influx of foreign investment would go far in providing the developing countries with badly needed capital, technology and managerial know-how. However, many of these countries place tremendous roadblocks in the way of foreign investors by restricting the proportion of foreign ownership in certain industries, restricting access to domestic credit markets, failing to provide a stable economic environment, and generally making their markets inaccessible to foreign investors.

Unfortunately, most of the liberalization policies which sound eminently sensible – the removal of trade barriers, dismantling of government subsidies to consumption and inefficient industries, privatization of government enterprises, realistic exchange rates, and opening up markets to foreign competition – will provoke the anger of entrenched interest groups and pose a real danger to the political stability of many governments, particularly the fledging Latin American democracies. We have already seen instances of resistance to the IMF-imposed austerity measures in Brazil when widespread riots occurred in 1983 in Sao Paulo and Rio de Janeiro. It is worth noting that this unrest occurred when the military were still in power in Brazil and that such instances of political violence under a military regime are quite uncommon occurrences. The point was ludicrously emphasized in Argentina in late 1983 when a local judge jailed Argentina's central bank president on charges that debt renegotiation agreements into which he had entered on behalf of his country violated local law. These instances are not limited to Latin America; work stoppages also occurred in Yugoslavia in reaction to government austerity measures which included the reduction in government subsidies on flour and bread.

However, Latin America, with its vast human and natural resources, is in a much better position to withstand the pains of adjustment than are the poorer African nations which are also facing debt problems. In order to mitigate the adjustment process and make the medicine more palatable, "a spoonful (or two) of sugar" is needed. This should take the form of additional net lending by the creditor nations and multilateral organizations such as the IMF, but also the World Bank and regional development banks such as the African and Inter-American Development Banks. The continued availability of long-term financing at lower interest rates (including, in some cases, at concessionary terms), will go a long way toward making possible the enactment of macroeconomic policies that will spur a resurgence of export growth, and by definition, overall economic growth and rising standards of living in the indebted developing countries. It must be emphasized, however, that additional lending is not the solution. It merely recognizes that in many countries the socio-political costs may be too burdensome and additional lending may be necessary to facilitate the adjustment process. However, lending should not take the place of adjustment.

Conclusion

Policies supportive of the adjustment process in the indebted nations are in the best interest of the United States. The benefits to the United States are not limited to issues of national security, but also of economic well-being. The concentration of nations with debt servicing problems in the Western Hemisphere speaks to both of these concerns. The trade flow between the United States and Latin America is truly a two-way street. Not only is the U.S. the major market for Latin American exports, but their economies are a major source of demand for U.S. goods and services. In fact, Mexico (together with Canada and Japan), is one of the three largest markets for American exports.

In its zealousness to protect American jobs from foreign competition, many legislators and interest groups have lost sight of the fact that the retrenchment of Latin American imports since 1982 has cost thousands of jobs in U.S. export and export-related sectors and regions. Border cities and towns in Texas, for instance, suffered along with the Mexicans from the austerity measures needed to deal with the debt problem. The real estate and tourist industries in Florida also felt the impact. And port cities such as Miami, New Orleans, and to a lesser extent Baltimore, major points of entry and departure for trade with Latin America, also suffered from the reduction in that trade. In testimony before the Joint Economic Committee of Congress, University of Pennsylvania Professor F. Gerard Adams noted that the U.S./Latin American trade balance suffered a $23 billion deterioration between 1981 and 1984. The deterioration mainly affected the manufacturing sector, including such industries as primary metals and motor vehicles. Reduced import demand on the part of the Latin American economies reduced real GNP in the United States by $19 billion, resulting in the loss of 800,000 jobs.

It should be evident from the foregoing that the most important requirement for the resolution, or at least, the longer-term management, of the debt problem resides in cooperation and understanding between the debtor and creditor nations. Both groups have much to lose from the unraveling of the process in which they are now embarked.

A major commitment to the ideals of free trade by both groups of nations will go a long way toward solving the problem. The right set of macroeconomic policies in the industrial nations will not only improve the outlook for their domestic economies but also provide the stimulus that the debtor countries need. Just as importantly, however, major domestic policy adjustments are needed in the indebted developing countries. Finally, an increase in net lending, at longer maturities and lower interest rates, will be necessary to mitigate the short-run adverse impact of adjustment in the debtor countries.

TRENDS IN COMMERCE NOTES ON TABLE II SEPTEMBER, 1985

by
Martin Lefkowitz

Gross National Product (GNP)–Gross National Product–the value of the output of goods and services–grew at a 2.0 percent annual rate in the second quarter, compared to a 0.3 percent growth rate of the first quarter. Personal consumption, residential investment and business investment grew rapidly while government purchases showed a smaller gain. Exports declined in the second quarter; however, there was no change in imports. In addition, real net inventory investment increased by only $8.3 billion compared to $19.1 billion in the first quarter.

The Services Sector–The services industries continue to be the growth sector of the economy. Comparisons between recent growth in the services sector and growth in goods underscore the dramatic differences in the trends. Employment in service sector establishments rose by 0.3 percent in July and is now 4.3 percent above its year-ago level. This compares with virtually no change in employment in the goods producing sector in July and a 0.7 percent increase in the last year.

Consumers continued to increase spending on services despite a lackluster performance in the goods sector. July data indicate that while retail sales were up 5.7 percent from their levels of last year, consumer expenditures on services soared by over 10 percent over the same period. Consumer purchases of services now comprise 51.1 percent of personal consumption expenditures compared to 49.8 percent in July 1984. In the past year, nearly 70 percent of the current dollar increase in personal consumption expenditures was for services, with less than one-third of the rise being attributable to increased outlays for goods. One rapidly expanding service has been travel. Revenue passenger miles flown, that is the number of passengers multiplied by the miles flown by each passenger, increased 5.3 percent in May from April, and was up nearly 15 percent from its level of last May.

Money Supply–The nation's money supply–as measured by M-1, currency in circulation plus demand deposits–increased by 0.8 percent in July, only about one-half the rate registered in June. The money supply, in the latest three month period, has been growing at a 14.4 percent seasonally adjusted annual rate. This is far above the Federal Reserve's target range of four to seven percent.

Employment–The civilian unemployment rate remained unchanged at 7.3 percent in July for the sixth month in a row. Civilian employment–as measured by the monthly survey of households–increased by 492,000 persons (seasonally adjusted) after declining by 590,000 from May to June. However, the number of jobs in July, before seasonal adjustment, increased by over one million. The reason for the stagnant rate of unemployment is the continued flow of new entrants and reentrants into the labor force that swells the ranks of the unemployed. However, the number of nonagricultural payroll jobs–as measured by the monthly survey of business establishments–increased by 243,000 in July, reflecting the continued strength of service sector and construction employment.

Prices–The Consumer Price Index for all urban consumers (CPI-U) increased 0.2 percent in July for the third consecutive month. The components of change were significantly different in each of the months. The May index rose primarily due to an increase in the housing component, which was offset by declines in food, apparel, and transportation. The June index showed price advances for a broader range of goods, with a much smaller gain in the housing component. The July index showed the largest increase in the other goods and services category due to a 1.6 percent increase in the cost of tobacco products, while gasoline prices declined 0.4 percent, after five months of increases. The pace of increase in consumer prices slowed to a 2.5 percent annual rate in the latest three month period, significantly below the 4.1 percent rate in the first quarter.

Wholesale prices of finished goods increased 0.3 percent in July, and were up only 0.9 percent from their year ago level. The index for energy prices turned down for the second consecutive month after substantial increases in April and May, while capital equipment prices were unchanged following a 0.4 percent increase in June. From July 1984 to July 1985, the finished goods index increased by only 0.9 percent. This increase is one fourth the 3.6 percent increase in consumer prices in the last twelve months, reflecting the fact that the Producer Price Index only measures the goods sector of the economy, while the Consumer Price Index measures both goods and services.

Crude goods prices declined in July for the eighth consecutive month. The July decline of 0.3 percent in crude materials prices was the smallest price drop within this volatile sector during the year. Crude materials prices in July were 9.1 percent below their level of a year ago. Crude food and feedstuff prices have fallen 12 percent in the last year. Prices of crude energy material are 5.2 percent below their year-ago levels and nonfood materials, excluding energy, are 6.9 percent below their levels of last year.

Housing Starts—Privately owned housing units were started at a seasonally adjusted annual rate of 1,654,000 in July, down 2.4 percent from the June level. So far, there has been no sign of the surge in new housing starts that many analysts were predicting would result from the decline in interest rates. In addition, building permits, usually an indicator of future activity in the home building industry, declined one percent in July.

Industrial Production—Industrial production data was recently revised back to 1967. The long run effect of the change was very slight. The revised data showed that between 1967 and 1984, industrial production increased by 3.0 percent instead of the 2.9 percent previously estimated. The data also indicated that the current recovery was slightly stronger than was previously estimated. The original data indicated a 22.5 percent increase in manufacturing output from the bottom of the last recession in November 1982 to May 1985. This compares to a revised 23.6 percent gain for the same period. July data showed a 0.2 percent increase in both manufacturing output and total industrial output compared to 0.3 percent in June. The sector that had registered strong gains in recent months, defense and space products, declined 0.3 percent in July, but the slack was made up by increased output of consumer durables. Production of consumer goods was up 0.3 percent in July, reflecting a gain in both durable and nondurable goods production. Automobiles were being assembled at an 8.3 million unit annual rate in July, up from 8.0 million units in June. Business equipment production fell 0.3 percent in July following a 0.2 percent decline in June. Previous data indicated that business equipment production had declined 1.3 percent in the first five months of the year, while the latest data shows an increase of 2.7 percent.

The capacity utilization data was also revised, along with the data on industrial production. Capacity utilization in manufacturing was unchanged in July as factories operated at 80.4 percent. Both primary metals and automobile manufacturing showed utilization rate gains of about three percent for the month. This brought the utilization rate for these industries back to their levels of earlier in the year. However, most industries showed small losses. Manufacturing capacity increased 0.8 percent in the second quarter of 1985 and was 3.3 percent above the second quarter of 1984.

Productivity—Nonfarm business productivity increased at a 1.0 percent annual rate in the second quarter, compared to a 3.1 percent decline in the first quarter. The productivity decline in the first quarter resulted from an increase of 3.7 percent in hours worked while output rose by only 0.5 percent. The fact that hours worked expanded seven times as fast as output in the first quarter may be indicative of problems in measuring the output of the growing services sector rather than a slowdown in output. The combined effect of more people at work, working longer hours and a small increase in output, caused unit labor costs in the nonfarm sector to soar at a seasonally adjusted annual rate of 8.4 percent in the first quarter. In the second quarter, output in the nonfarm business sector grew by 2.2 percent, and the number of hours worked increased by 1.2 percent.

Interest Rates—At 9.5 percent, the prime interest rate is 3.5 percentage points below last summer's peak, and out of the double digit range for the first time in nearly seven years. However, during July, most interest rates began to trend back up. The federal funds rate ended July about half a point higher than at the beginning of the month, and most long and short-term Treasury bill rates were between 0.3 and 0.4 percentage points higher during the same period.

Business Failures and Formations—Total bankruptcies, according to Dun and Bradstreet, increased to 27,471 in the first six months of 1985, this was two percent more than the number of bankruptcies in the same six months of 1984. Dun and Bradstreet's Index of Business Failures indicates that business failures declined in mid-July and were at their lowest level since March. The index of business failures, which uses October 1983 as a base of 100, decreased to 97.7 in the week ending July 12, 1985. In addition, business discontinuances and business closings were also trending downward in mid-July, each falling about six percent in the last month.

Dun and Bradstreet reported that 635,000 new business corporations were formed in 1984, an increase of 5.8 percent from the previous year. Fifteen states had increases of ten percent or more, and eight of the nine census regions reported more new business incorporations in 1984 as compared to 1983. The only region reporting a decrease in business corporations was the West South Central, while the New England region reported the largest annual gain with an increase of 11.5 percent in 1984, twice the national average. The states reporting the largest increases in new corporations for 1984 were Vermont, Georgia, and South Carolina. The number of new business corporations formed in December 1984 was 53,305 (seasonally adjusted), 3.8 percent more than the same month a year earlier. Ten states registered increases of more than ten percent from their year-ago levels in December, with Vermont, New Jersey and Arizona reporting the largest increases.

TABLE II
TRENDS IN COMMERCE

	Current Period		Previous Period	Year Ago	Percent Change From Previous Period	Percent Change From Year Ago
Population (Millions) [a]	May/85	238.6	238.4	236.5	0.1	0.9
Gross National Product ($B)	II/85	3,855.1	3,810.6	3,644.7	1.2	5.8
Gross National Product (72$B)	II/85	1,671.5	1,663.5	1,638.8	0.5	2.0
Money Supply (M1) ($B)	Jul/85	595.9	591.2	546.9	0.8	9.0
PEOPLE AND THEIR MONEY						
Personal Consumption Expenditures ($B)	Jul/85	2,520.5	2,510.1	2,350.5	0.4	7.2
Personal Consumption Expenditures (72$B)	Jun/85	1,105.1	1,104.6	1,071.0	0.0	3.2
Disposable Personal Income ($B)	Jul/85	2,708.4	2,696.3	2,589.0	0.4	4.6
Disposable Personal Income (72$)	Jun/85	1,187.1	1,222.1	1,172.4	−2.9	1.3
Personal Savings Rate (%)	Jun/85	4.3	5.0	5.6	−0.7[b]	−1.3[b]
Civilian Employment (millions)	Jul/85	106.9	106.4	105.4	0.5	1.4
Civilian Unemployment Rate (%)	Jul/85	7.3	7.3	7.5	0.0[b]	−0.2[b]
Average Hourly Earnings	Jul/85	$8.57	$8.57	$8.35	0.0	2.6
Consumer Price Index (All Urban, 67=100) [a]	Jul/85	322.8	322.3	313.0	0.2	3.6
Purchasing Power of the Dollar (67=$1.00) [a]	Apr/85	0.310	0.311	0.321	−0.186	−3.44
Prime Interest Rate (%) August 31, 1985		9.5	9.5	13.0	0.0[b]	−3.5[b]
Retail Sales ($)	Jul/85	113.7	113.3	107.6	0.4	5.7
SERVICES SECTOR						
Employment in Services (Millions)	Jul/85	72.7	72.4	69.8	0.4	4.2
Consumer Purchases of Service ($B)	Jul/85	1,288.7	1,281.8	1,171.1	0.5	10.0
Consumer Purchases of Service (72$B)	Jun/85	513.2	509.4	490.0	0.7	4.7
Revenue Passenger Mileage Flown Major Airlines (Millions) [a]	May/85	26,610	25,269	23,204	5.3	14.7
BUSINESS PROFITS AND OUTPUT						
Nonfinancial Corporate Profits ($B) [a]						
Before Tax [a]	II/85	221.1	222.3	246.0	−0.5	−10.1
After Tax [a]	II/85	136.5	137.0	150.2	−0.4	−9.1
Industrial Production (67=100)	Jul/85	124.9	124.7	123.2	0.2	1.4
Capacity Utilization Rate (Mfg.) (%)	Jul/85	80.4	80.4	81.7	0.0[b]	−1.3[b]
New Housing Starts (thou. units)	Jul/85	1,654.0	1,694.0	1,730.0	−2.4	−4.4
Net Business Formation (67=100) [a]	Jun/85	115.4	112.2	117.0	2.9	−1.4
New Business Incorporations (Thousands)	Dec/84	53.5	53.5	51.6	0.0	3.8
BUSINESS COSTS						
Unit Labor Costs (nonfarm) (77=100)	II/85	164.5	163.3	157.6	0.7	4.4
Unit Nonlabor Costs (77=100)	II/85	161.2	160.3	156.8	0.6	2.8
Producer Price Indices (67=100)						
Crude Materials	Jul/85	301.6	303.3	331.3	−0.6	−9.0
Intermediate Goods	Jul/85	317.8	318.8	320.9	−0.3	−1.0
Finished Goods	Jul/85	294.0	293.5	291.8	0.3	0.9
FEDERAL SPENDING AND DEBT						
Federal Spending Index (67=100)	Jun/85	544.4	611.0	542.7	−10.9	0.3
Federal Government Debt Outstanding ($B) [a]	Mar/85	1,715.1	1,702.8	1,468.3	0.7	16.8
INTERNATIONAL TRADE						
Exports of Goods & Services ($B)	II/85	349.4	360.7	362.4	−3.1	−3.6
Imports of Goods & Services ($B)	II/85	442.8	435.2	421.1	1.7	5.2
Balance on Goods & Services ($B)	II/85	−93.4	−74.5	−58.7	25.4	59.1
WHAT'S AHEAD?						
Index of Leading Indicators (67=100) [a]	Jul/85	168.7	168.0	163.9	0.4	2.9

NOTES: All data seasonally adjusted unless otherwise noted
[a] Not seasonally adjusted
[b] Percentage point difference

Federal Spending—The "Federal Spending Index," a U.S. Chamber devised measure of the monthly change in federal expenditures, increased 4.1 percent in June from its year-ago level, about the same as the inflation rate. However, in the first nine months of fiscal year 1985, federal expenditures increased by 10.9 percent, nearly three times as fast as prices, indicating a real increase in federal spending of about seven percent from the year-ago level. Federal receipts, during the same period, have risen by 11.3 percent as a result of double digit increases in personal income taxes, corporate income taxes, and social insurance taxes. The data on tax receipts indicates that the deficit is the result of excessive growth in federal outlays rather than the 1981 tax cuts. This shows the futility of seeking to cut the deficit by means of even higher taxes. If the federal deficit is growing at a time of economic expansion and double digit increases in federal tax receipts, then any attempt to raise tax revenue even further will result in total abandonment of efforts to control federal outlays.

Personal Savings—Personal savings increased from 4.5 percent of after-tax income in the first quarter to 5.3 percent of after-tax income in the second quarter of 1985. The reason for this increase in the savings rate in the second quarter was that the tax refunds which were delayed in the first quarter of the year finally reached consumers in the second quarter. On a monthly basis the personal savings rate peaked at 6.2 percent of after-tax income in May when the IRS was mailing out tax refunds at a feverish pace to meet the May 31 deadline and avoid paying interest to taxpayers. Since May the savings rate has dropped almost by half from 6.2 percent of disposable income to 3.4 percent in both June and July.

Retail Sales—Retail sales increased 0.4 percent in July following a revised decline of 1.4 percent in June, which had earlier been reported as a 0.8 percent decline. Retail sales for the latest three month period were up 5.3 percent from the previous three months, indicating that the sales increase over the latest three months is at more than a 20 percent annual rate. Durable goods sales rose 0.7 percent in July, after declining 1.3 percent in the previous month; nondurable goods sales inched up 0.2 percent after falling 0.7 percent in June. The bright spots in the retail sales report were the gains in department store sales, up 2.2 percent, and hardware store sales which showed a 5.0 percent increase for the month.

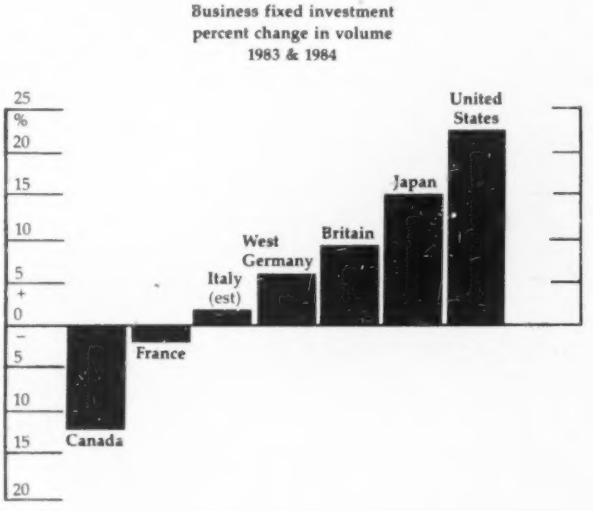
Trade Deficit—The trade deficit continued to grow in the second quarter. On a goods and services basis, the trade deficit increased to $93.4 billion in the second quarter from $74.5 billion in the first quarter. The deterioration is in large part due to an $11.3 billion decline in nominal exports, while nominal imports increased by $7.4 billion. On a monthly basis, the merchandise trade deficit declined by $2.9 billion in July to $10.5 billion, following three successive months of widening deficits. The decline was mainly due to a lower level of imports while exports remained unchanged. Petroleum imports decreased 19.3 percent as a result of a 91 cents per barrel drop in oil prices and a lower volume of imports. Other categories of goods reporting lower levels of imports in July were automobiles, iron and steel plates and sheets, and telecommunication equipment. The value of July exports was virtually unchanged from June.

What's Ahead—The composite index of leading indicators, designed to predict future movements in aggregate economic activity, increased 0.4 percent in July, with six of the eleven available indicators up, three were down and two were unchanged. This follows a revised 0.4 percent increase for the month of June that was previously reported as a 1.0 percent gain.

UNITED STATES IS THE LEADER IN BUSINESS FIXED INVESTMENT

For the past two years, business investment has been growing in America, Great Britain, and Japan. As the chart shows, American companies, stimulated by new tax breaks, invested more and earlier than in previous economic recoveries. On the other hand, British companies have invested for the opposite reason: to use capital allowances that were about to be phased out. Japanese companies continue to maintain a steady investment trend.

Among some of the other OECD countries, Canadian investment was discouraged by low commodity prices. French investment has barely risen for the last ten years, but West German companies are spending again.



Source: Organization for Economic Co-operation and Development